2nd Civ. No. B194463

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA
SECOND APPELLATE DISTRICT
DIVISION ONE

JERRY HILL, JOSEPHINE HILL, WILSON MALLORY AND NORENE MALLORY

Individually and on Behalf of the Plaintiff Class
Plaintiffs and Appellants

v.

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY
Defendant and Respondent

Appeal from a Summary Judgment of the Los Angeles County Superior Court
The Honorable Carolyn B. Kuhl, Judge Presiding
Case No. BC194491 (Class Action)

APPELLANTS' OPENING BRIEF

J. Michael Hennigan (SBN 59491)
Robert L. Palmer (SBN 181462)
Mark Anchor Albert (SBN 137027)
HENNIGAN, BENNETT & DORMAN LLP
865 South Figueroa Street, Ste. 2900
Los Angeles, California 90017
Telephone: (213) 694-1200

Timothy J. Morris (SBN 80440)
GIANELLI & MORRIS
A Law Corporation
626 Wilshire Boulevard, Ste. 800
Los Angeles, California 90012
Telephone: (213) 489-1600

Raymond E. Mattison (SBN 72850)
ERNST & MATTISON
1020 Palm Street, P.O. Box 1327
San Luis Obisbo, California 93406
Telephone: (805) 541-0300

Robert S. Gerstein (SBN 35941)
LAW OFFICES OF ROBERT S. GERSTEIN
1717 4th Street, 3rd Flr.
Santa Monica, California 90401
Telephone: (310) 393-5582

Attorneys for Plaintiffs and Appellants
JERRY HILL, JOSEPHINE HILL, WILSON MALLORY AND NORENE MALLORY
Individually and on Behalf of the Plaintiff Class

TABLE OF CONTENTS

(Page)

I. INTRODUCTION 1

II. STATEMENT OF THE CASE 3

III. STATEMENT OF FACTS 4

A. Evidence Regarding Plaintiffs' Contractual Dividend Rights. 4

B. Evidence Regarding The Board's Consideration Of And Deliberation On Management's Dividend Decisions. 5

C. Evidence As To Whether The Board Was Adequately Informed On Dividend Issues. 6

D. Evidence Regarding The Growth Of The Surplus During The Class Period. 7

E. Evidence That The Board's Dividend Actions Were Inconsistent And Arbitrary. 8

F. Evidence That State Farm Misrepresented Its Dividend Policies And Surplus Status To Policyholders. 8

IV. STATEMENT OF APPEALABILITY 9

V. STANDARD OF REVIEW 9

VI. ARGUMENT: THE SUMMARY JUDGMENT MUST BE REVERSED BECAUSE PLAINTIFFS CREATED TRIABLE ISSUES OF FACT AS TO WHETHER THE BUSINESS JUDGMENT RULE IS APPLICABLE HERE. 9

A. The Background 11

1. Mutual Policyholders' Rights To Dividends. 11

B. The Board Never Deliberated On Or Made A Dividend Decision Of Its Own. 14

1. There Is A Triable Issue Of Fact Whether The Board Ever Deliberated About Management's "Business Model" Excluding Invested Surplus From Consideration. 14

TABLE OF CONTENTS (cont'd)

(Page)

2. The Board Did No More Than Rubber-Stamp Management's Dividend Recommendations 16

3. The Board Never Deliberated About The Purported Provision Of Rate Reductions In Lieu Of Dividends. 18

C. Triable Issues Of Fact Exist Whether The Board Was Adequately Informed In Its Deliberations On Dividends 19

1. The Standard For Adequate Information 19

2. The Board's Dividend Decisions Could Not Be Adequately Informed Without Knowledge Of State Farm's Actual Surplus Needs And The Level Or Range Of Excess Surplus. 20

3. The Board Had Inadequate Information About State Farm's Surplus Needs And The Level Of Its Excess Surplus. 24

a) State Farm's Own Evidence Creates A Triable Issue Whether There Was Adequate Information. 24

b) Plaintiffs' Experts Further Support The Existence Of A Triable Issue, But Their Testimony Was Wrongfully Disregarded By The Trial Court. 26

1) Toothman's Testimony Should Not Have Been Excluded. 26

2) The Trial Court Erred In Reading Bebchuk's Declaration Too Narrowly. 29

4. Board Members Were Misinformed About Their Fundamental Legal Responsibilities 30

5. Board Members Were Ignorant Of The Tax Consequences Of Declaring Dividends. 33

D. Plaintiffs' Evidence Creates Triable Issues Of Fact Whether The Board's Dividend Decisions Were Totally Without Merit. 33

1. Because The Board's Dividend Decisions Were Uninformed And Undeliberated They Also Were Totally Without Merit 33

TABLE OF CONTENTS (cont'd)

(Page)

2. Triable Issues Of Fact Exist As To Whether The Board's Dividend Decisions Were "Totally Without Merit" In Substance. 34

a) Evidence Regarding Management's Policy Of Declaring Dividends Solely On The Basis Of A Portion Of Underwriting Gains And Never From Surplus. 35

b) Evidence Regarding State Farm's Being Unable to Raise Capital And Having Met Its Responsibilities By Reducing Premium Rates. 36

1) Inability to Raise Capital in the Stock Market. 37

2) Providing Rate Reductions In Lieu Of Dividends..................... 37

c) The Actual Level Of Surplus Could Not Be Justified By Any Measure. 38

d) Evidence That State Farm's Dividend Decisions Were Erratic And Inconsistent By Any Standard... 40

E. Triable Issues Of Fact Exist Whether The Board's Withholding Of Dividends Was Dishonest Or Fraudulent... 42

1. The Board's Failure To Disclose Management's Dividend Policy To Policyholders Was Evidence Of Bad Faith.................................. 43

2. The Board's Annual Reports To Policyholders Were Materially Misleading. 45

VII. CONCLUSION 51

TABLE OF AUTHORITIES

(Page)

Cases

20th Century Ins. Co. v. Garamendi
(1994) 8 Cal. 4th 216 13

Abrams v. Koether
(D.N.J. 1991) 766 F. Supp. 237 .... 10, 15

Aguilar v. Atlantic Richfield Co.
(2001) 25 Cal. 4th 826 .... 9, 20

Alef v. Alta Bates Hospital
(1992) 5 Cal.App.4th 208 .... 27, 29

Ankele v. Workingmen's Relief Soc'y, A. U. V. O.
(1913) 182 Ill. App. 470 14

Artiglio v. Corning
(1998) 18 Cal. 4th 604 9

Barnes v. State Farm Mut. Auto. Ins. Co.
(1993) 16 Cal. App. 4th 365 34

Blasius Indus. v. Atlas Corp.
(Del. Ch. 1988) 564 A.2d 651 2

Brown v. Colm
(1974) 11 Cal. 3d 639 28

Canadian Ins. Co. v. Ehrlich
(1991) 229 Cal. App. 3d 383 4

Chapin v. Benwood Foundation, Inc.
(Del. 1979) 402 A.2d 1205
(*aff'd sub nom. Harrison v. Chapin* (Del. 1980) 415 A.2d 1068) 16

Coons v. Home Life Ins. Co.
(Ill. 1938) 368 Ill. 231 17

Davidowitz v. Edelman
(N.Y. Sup. Ct. 1992) 153 Misc. 2d 853 16

TABLE OF AUTHORITIES (cont'd)

(Page)

Dinicu v. Groff Studios Corp.
(1999) 257 A.D.2d 218 12

Doggett v. North American Life Ins. Co.
(1947) 396 Ill. 354 31

Duffy v. Mutual Benefit Life Ins. Co.
(1926) 272 U.S. 613 12

F. H. Hill Co. v. Barmore
(1920) 220 Ill. App. 222 49

F.D.I.C. v. Lauterbach
(7th Cir. 1980) 626 F.2d 1327 50

Fe Bland v. Two Trees Management Co.
(1985) 489 N.E.2d 223 12

Feit v. Leasco Data Processing Equip. Corp.
(E.D.N.Y. 1971) 332 F. Supp. 544 .... 21, 47

Ferris Elevator Co., Inc. v. Neffco, Inc.
(1996) 285 Ill. App.3d 350 10

Flaherty v. Weinberg
(1985) 303 Md. 116 49

Ford v. Ford Mfg. Co.
(1921) 222 Ill. App. 76 8

Gafcon, Inc. v. Ponsor & Associates
(2002) 98 Cal.App.4th 1388 30

Gaillard v. Natomas Co.
(1989) 208 Cal.App.3d 1250 20

Graham v. Taylor Capital Group
(D. Del. 2001) 135 F. Supp. 2d 480 49

Guz v. Bechtel Nat., Inc.
(2000) 24 Cal. 4th 317 9

(Page)

Hall v. John S. Isaacs & Sons Farms, Inc.
(Del. Ch. 1958) 146 A.2d 602 50

Hall v. Woods
(1927) 325 Ill. 114 .... 10, 42

Hilton Hotels Corp. v. ITT Corp.
(D. Nev. 1997) 978 F. Supp. 1342 32

Holland v. Stenhouse
(N.D. Ill. Mar 1, 1991, No. 87-C-3086) 1991 U.S. Dist. LEXIS 2518 26

Hoye v. Meek
(10th Cir. 1986) 795 F.2d 893 50

In re Illinois Valley Acceptance Corp.
(S.D. Ill. 1982) 531 F. Supp. 737 50

In re RJR Nabisco, Inc. Shareholders Litigation
(Del.Ch. Jan. 31, 1989, C.A. No. 10389) 1989 Del.Ch.LEXIS 9 20

In re RSL COM Primecall, Inc.
(Bankr. S.D.N.Y., Dec. 11, 2003, Nos. 01-1145 & 01-1146)
2003 Bankr. LEXIS 163 10

Jeffer, Mangels & Butler v. Glickman
(1991) 234 Cal. App. 3d 1432 27

Johnson v. Central Standard Life Ins. Co.
(1968) 102 Ill.App.2d 15 .... 12, 32, 50

Johnson v. City of Loma Linda
(2000) 24 Cal. 4th 61 9

Kelly v. Bell
(Del. Ch. 1969), 254 A.2d 62
(*aff'd* 266 A.2d 878 (Del. Supr.1970) 50

Keystone Mut. Casualty Co. v. Driscoll
(W.D. Pa. 1942) 44 F. Supp. 658 13

Lipsman v. Reich
(N.Y. Misc. 1939) 173 Misc. 294 21

(Page)

Lower v. Lanark Mut. Fire Ins. Co.
(1983) 114 Ill. App. 3d 462 20

Lubin v. Equitable Life Assur. Soc.
(1945) 326 Ill. App. 358 .... 12, 14

Malone v. Brincat
(Del. 1998) 722 A.2d 10 50

Manderville v. PCG & S Group, Inc.
(2007) 146 Cal.App.4th 1486 45

Marhart, Inc. v. CalMat Co.
(Del. Ch. Apr. 22, 1992, C.A. No. 11,820) 1992 Del. Ch. LEXIS 8 50

Merrill v. Navegar, Inc.
(2001) 26 Cal. 4th 465 9

Modern Life & Accident Ins. Co. v. Comm'r
(7th Cir. 1969) 420 F.2d 36 .... 13, 35

Molko v. Holy Spirit Assn.
(1988) 46 Cal.3d 1092 .... 9, 17

Mutual Fire Ins. Co. v. United States
(D. Pa. 1943) 50 F. Supp. 665 22

National Chiropractic Insurance Co. v. United States
(8th Cir.1974), 494 F.2d 332 32

Ohio State Life Ins. Co. v. Clark
(6th Cir. 1960) 274 F.2d 771 11

Parish v. Maryland & Virginia Milk Producers Ass'n,
(1968) 250 Md. 24, 242 A.2d 512 49

Penn Mut. Life Ins. Co. v. Lederer
(1920) 252 U.S. 523 21

People v. Mitchell
(2000) 189 Ill. 2d 312 4

(Page)

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.
(Del. 1986) 506 A.2d 173 43

Romanik v. Lurie Home Supply Center, Inc.
(1982) 105 Ill.App.3d 1118 10

Romanik v. Lurie Home Supply Center, Inc.
(1982) 105 Ill. App. 3d 1118 42

RSL Communs. PLC v. Bildirici
(S.D.N.Y. Sept. 14, 2006, No. 04-CV-5217),
2006 U.S. Dist. LEXIS 67548 .... 10, 15

Silver v. Allard
(N.D. Ill. 1998) 16 F. Supp. 2d 966 .... 10, 14

Stamp v. Touche Ross & Co.
(2003) 263 Ill. App. 3d 1010 20

State Farm Mut. Auto. Ins. Co. v. Sup. Ct.
(2003) 114 Cal.App.4th 434 .... 4, 32, 42

Thompson v. White River Burial Ass'n
(8th Cir. 1950) 178 F.2d 954 .... 13, 24, 35

Tortorella v. Castro
(2006) 140 Cal. App. 4th 1 30

Willmschen v. Board of Directors of the Trinity Lakes Improvement Assoc.
(2005) 362 Ill. App. 3d 546 12

Winger v. Chicago City Bank & Trust Co.
(1946) 394 Ill. 94 12

Winger v. Richards-Wilcox Mfg. Co.
(1961) 33 Ill. App. 2d 115 43

TABLE OF AUTHORITIES (cont'd)

(Page)

Statutes

215 ILCS § 5/42(1) 12

215 ILCS § 5/54(2) 14

215 ILCS § 5/54(3)(a) 5

Other Authorities

2 NAIC RESEARCH Q.1 (Oct. 1996) 40

3A Fletcher, CYCLOPEDIA CORPORATIONS § 837.70 (1975) 43

I. INTRODUCTION

This is an appeal from a grant of summary judgment upholding State Farm Mutual Automobile Insurance Company's ("State Farm") business judgment rule defense to a class action in which millions of current and former policyholders assert their dividend rights to share, as owners of this mutual company, in the enormous surplus State Farm has amassed.

This Court should reverse the summary judgment because Plaintiffs have presented evidence creating triable issues of fact as to:

(1) whether the Board ever deliberated, or made a decision on, management's practice of limiting the source of dividends to a narrow subset of the underwriting gains component of current operating income measured state-by-state, denying Plaintiffs any benefit from the burgeoning surplus generated by investment of their premiums;

(2) whether the Board's decisions to withhold dividends which could have been paid out of State Farm's vast surplus were adequately informed given the absence of analysis of surplus needs and the Board's misunderstanding of its responsibilities to policyholders;

(3) whether the Board's dividend and surplus decisions were "totally without merit" because they were constrained by management's arbitrary policy of completely excluding surplus from dividend consideration, and because they allowed the surplus to grow to levels unjustifiable by any standard, and;

(4) whether the Board made its dividend decisions fraudulently and in bad faith, concealing from Plaintiffs the basis for its decisions (including management's restrictive dividend policy) under cover of financial reports which underreported the true amount of State Farm's surplus.

Because each of these questions either raises a recognized exception to the business judgment rule or questions the fulfillment of a prerequisite to its application, a triable issue of fact as to any *one* of them independently compels reversal of the summary judgment.

The business judgment rule shields the decisions of corporate boards -- including boards of mutual insurance companies -- from judicial interference when those boards have acted deliberatively, in good faith and based on adequate information to serve the interests of shareholders or policyholders.

But where there is evidence that a board failed to deliberate or act on an important issue, was ill-informed, made decisions arbitrarily and in bad faith, failed to take account of the Plaintiffs' rights and interests, or concealed its decisions from Plaintiffs in incomplete and misleading annual reports, the business judgment rule will not shield its actions from the jury's scrutiny.

The need to ensure that corporations do not abuse the business judgment rule to preclude scrutiny of bad faith, uninformed decisions is especially compelling in the context of mutual insurance companies.

While Plaintiffs have a statutory and contractual right to insurance at cost, to choose management, and to have the corporate board put their interests before all others in making decisions, they lack the means of internal control shareholders in ordinary business corporations use to compel respect for their rights. *Blasius Indus. v. Atlas Corp.* (Del. Ch. 1988) 564 A.2d 651, 659. In contrast to shares of corporate stock, State Farm's policies are non-transferable, entitle the policyholder to only one vote, and can be cancelled at any time. Nor can policyholders wage a proxy contest or effectively nominate or elect board members who might advance their interests. AA-8, 02062-02063.[1]

---

[1] References to Appellants' Appendix herein are in the following format: "AA-(Vol. #), (page)-(page)."

Indeed, the State Farm Board has made a drastic departure from the norm that mutual policyholders have exclusive control over management in recent years by amending its by-laws (without notice or disclosure to Plaintiffs) to make it virtually impossible for policyholders to nominate, much less elect, directors to challenge management's dividend and surplus practices. AA-8, 02062-02063 and AA-8, 02163-02168. Only the courts offer policyholders realistic recourse for vindication of their statutory and contractual rights. *Id.*

Contrary to summary judgment jurisprudence, the trial court adopted narrowly-selected statements in the declarations and deposition testimony of certain State Farm witnesses as "undisputed," though they were directly contradicted by other testimony and State Farm's corporate minutes and internal memoranda. The trial court weighed the sufficiency of the evidence, failed to construe it strictly against State Farm and liberally in Plaintiffs' favor, and erroneously excluded testimony of Plaintiffs' actuarial expert, Michael Toothman. The summary judgment must be reversed.

II. STATEMENT OF THE CASE

The complaint in this national class action was filed on July 17, 1998, and has been before this Court several times.

In *State Farm Mut. Auto. Ins. Co. v. Sup. Ct. (Hill)* (Jan. 30, 2001), B133264 (slip op.) ("*Hill I*"), the Court reversed the trial court's dismissal of the complaint, rejecting State Farm's contention that the Company and its Board had unreviewable discretion with respect to whether, when and on what basis to issue dividends to policyholders, and that the Illinois "business judgment rule" is applicable.

In *State Farm Mut. Auto. Ins. Co. v. Sup. Ct.* (2003) 114 Cal.App.4th 434 ("*Hill II*"), the Court held that this case is governed by Illinois law; and that the Illinois "business judgment rule" must be rebutted before liability can be established.

On June 14, 2005, the trial court rejected State Farm's motion to dismiss on *forum non conveniens* grounds and, on October 19, 2005, this Court denied State Farm's writ petition seeking review of that order.

On August 18, 2006, the trial court entered judgment against Plaintiffs, granting State Farm's summary judgment motion that undisputed facts established that State Farm's dividend decisions are protected by the business judgment rule.

On September 22, 2006, the trial court denied Plaintiffs' motion for a new trial.

Plaintiffs filed and served a timely notice of appeal on October 2, 2006.

III. STATEMENT OF FACTS

A. EVIDENCE REGARDING PLAINTIFFS' CONTRACTUAL DIVIDEND RIGHTS.

In most states between 1983-1989, and in some states through the 1990s, State Farm's policies provided that Plaintiffs would be "*entitled to . . . share in the earnings and savings of the company* in accordance with the dividends declared by the Board of Directors[.]" AA-11, 02924 (emphasis added)].[2] After 1989, the policies in most states provided that Plaintiffs were "entitled to . . . receive dividends the Board of Directors *in its discretion* may declare[.]" AA-11, 02952 (emphasis added).

---

[2] "The word 'entitled,' in its usual sense, means 'to give a right or legal title to'" *People v. Mitchell* (2000) 189 Ill. 2d 312, 331; *accord Canadian Ins. Co. v. Ehrlich* (1991) 229 Cal. App. 3d 383, 392.

Throughout the Class Period, State Farm's bylaws (which are part of its insurance contracts) provided that:

> [s]ubject to the provisions of law regarding return of excess premiums, the Board of Directors may authorize from time to time such refunds or credits to policyholders *from the savings and gains* of the Corporation . . . *as may, in their judgment, be proper, just and equitable*.

AA-11, 02964 (emphasis added).[3]

State Farm has acknowledged that the "savings and gains" referenced in its contracts and bylaws is "earned surplus," AA-13, 03730–03731 and AA-13, 3739–3740, defined in Illinois law as all surplus generated from operations (in contrast to contributed capital). 215 ILCS § 5/54(3)(a).[4]

B. EVIDENCE REGARDING THE BOARD'S CONSIDERATION OF AND DELIBERATION ON MANAGEMENT'S DIVIDEND DECISIONS.

Under State Farm's "long-standing, overall business model" (Motion at 33:20-25) policyholders received dividends only to the extent that State Farm received higher than expected underwriting income from their respective states during the previous policy period. AA-5, 01362-01363.

State Farm's President and Director Vincent Trosino testified that the Board never considered returning any portion of the Company's accumulated savings and gains to policyholders. AA-10, 02911–02912. Board minutes and

---

[3] By statute, the Board's dividend distributions must be made from the company's "earned surplus," *i.e.*, from the company's net worth exclusive of initial seed capital ("contributed surplus"). 215 ILCS 5/54(3)(a). As State Farm itself concedes, "Earned surplus *is* the savings and gains of the Corporation." AA-13, 03740 (emphasis added); *see also* AA-13, 03731 (same).

[4] "Earned surplus" is "[t]hat species of surplus which has been generated from profits as contrasted with paid-in surplus." BLACK'S LAW DICTIONARY 456 (5th ed. 1979).

meeting materials during the Class Period confirm that management never presented that practice to the Board for consideration, and the Board never deliberated about it. AA-14-16, 03769-04447 (all Board minutes during the Class Period).

In the nine years before this action, the Board considered a dividend six times, always in response to a management proposal. DSOF No. 110; AA-12, 03274. Each time, management presented the Board with a one page "worksheet" identifying the States which qualified for dividends under the business plan, and recommending dividends to policyholders in those States representing a portion of their respective underwriting results in excess of management-selected targets. AA-13, 03742-03747; AA-22, 06037-06042; AA-13, 03271-03274. The worksheets included no analysis of State Farm's earnings, savings, investment gains, or other surplus. *Id.* Each time, the Board approved the recommendation without modification or discussion of alternatives. AA-12, 03324, 03265.

Former Director Wendy Gramm could not recall an instance in which the Board disagreed with management on any subject whatever. AA-12, 03387.

C. EVIDENCE AS TO WHETHER THE BOARD WAS ADEQUATELY INFORMED ON DIVIDEND ISSUES.

State Farm presented evidence that the Board received regular information from management concerning the Company's overall financial position, including the level of State Farm's surplus at any given point of time. AA-5, 01374-01377.

However, State Farm's Chief Actuary, Gary Grant testified that the Board never received an actuarial analysis to determine how large a surplus State Farm needed to cover all of its risks (AA-12, 03231–03235) -- an analysis which presents "uniquely actuarial issues" according to State Farm's corporate

governance expert. AA-11, 03201–03202 .[5] Two of Plaintiffs' experts, Professor Lucian Bebchuk and Michael Toothman, confirmed such analysis was essential to making informed dividend decisions for mutual companies.[6] AA-8, 02039; AA-9, 02496-02499.

Mr. Grant's subordinate, actuary Hayward, gave conflicting testimony to the effect that he did such an analysis during the Class Period, but admitted that it was not put into writing until after the Class Period. AA-11, 03007; *see also* AA-12, 03231–03237.

Directors from the Class Period confirmed that the Board did not receive information about or discuss the adequacy of the surplus for State Farm's needs. AA-12, 03325–03326; AA-12, 03380; AA-12, 03296.

Prof. Bebchuk and Mr. Toothman concluded that the Board lacked information essential to making informed dividend decisions. AA-8, 02033, 02039–02042; AA-9, 02496-02499.

D. EVIDENCE REGARDING THE GROWTH OF THE SURPLUS DURING THE CLASS PERIOD.

During the Class Period, State Farm's reported surplus grew by $41 billion -- from under $9 billion to nearly $50 billion -- a jump of 463%. AA-9, 02513-02514. Meanwhile, over that fifteen-year period, policyholders received only $2.8 billion in dividends. *Id.*

---

5 Mr. Grant confirmed that his 1991 memo -- the only actuarial analysis that was presented to the Board during the Class Period -- did not attempt to analyze what level of surplus would be adequate, inadequate, or excessive. AA-12, 03231. There is no indication in the minutes that the Board ever discussed or considered that memo. AA-14-16, 03769-04447.

6 The exclusion of Mr. Toothman's testimony in that regard is an issue in this appeal.

While maintaining that 2:1 premium-to-surplus ratio "is considered to be prudent in taking into consideration the kinds of risk that the Company's surplus is intended to withstand[]" (AA-11, 03135), State Farm also grew its surplus as compared to premium during the Class Period to many times that "prudent" amount by 1998. AA-9, 02503-02504 and 02519.

Internal State Farm documents show concern about the size of the surplus. AA-12, 03221–03227; AA-13, 03647–03672. But no Board minutes or other documents reflect Board consideration of surplus size in relation to surplus needs, much less whether the surplus was sufficiently robust to warrant additional or larger dividends. *See Ford v. Ford Mfg. Co.* (1921) 222 Ill. App. 76, 82.

E. EVIDENCE THAT THE BOARD'S DIVIDEND ACTIONS WERE INCONSISTENT AND ARBITRARY.

Prof. Bebchuk also concluded that, seen collectively, the Board's dividend decisions failed basic tests of rationality and logic. AA-8, 02045–02048. For example, the pattern of years in which dividends were not even discussed, as compared to others in which they were declared, cannot be rationalized either in terms of relative surplus level or relative levels of underwriting profit. AA-8, 02049-02051; AA-9, 02513-02514; AA-12, 03323 (no deliberation or consideration of a dividend in 1995).

F. EVIDENCE THAT STATE FARM MISREPRESENTED ITS DIVIDEND POLICIES AND SURPLUS STATUS TO POLICYHOLDERS.

State Farm sent policyholders a report of its financial condition annually, including the amount of surplus and the amount of dividends paid the prior year. AA-13, 03503-03534. Plaintiffs' experts testified that the format of the reports and the figures in them were manipulated to give the impression that the surplus available for dividends was much smaller than was actually the case. In addition, the Board did not disclose management's policy of severing all surplus from

dividend consideration. AA-8, 02170–02176; AA-9, 02421 and AA-9, 02424-02425, 02427-02428; AA-9, 02507-02509; AA-8, 02059–02062; AA-12, 03436 and AA-13, 03638.

IV. STATEMENT OF APPEALABILITY

The judgment appealed from finally disposed of this action.

V. STANDARD OF REVIEW

Summary judgments are reviewed de novo. *Merrill v. Navegar, Inc.* (2001) 26 Cal. 4th 465, 476; *Johnson v. City of Loma Linda* (2000) 24 Cal. 4th 61, 67-68. This Court must consider "all the evidence set forth in the moving and opposition papers except that to which objections have been made and sustained," *Guz v. Bechtel Nat., Inc.* (2000) 24 Cal. 4th 317, 334, including all inferences reasonably deducible from the evidence. *Artiglio v. Corning* (1998) 18 Cal. 4th 604, 612. The affidavits of the moving party should be construed strictly and those of the opponent liberally. Doubts as to the propriety of granting the motion must be resolved against the moving party. *Molko v. Holy Spirit Assn.* (1988) 46 Cal.3d 1092, 1107 (*superseded in part by statute on other grounds, Aguilar v. Atlantic Richfield Co.* (2001) 25 Cal. 4th 826).

VI. ARGUMENT: THE SUMMARY JUDGMENT MUST BE REVERSED BECAUSE PLAINTIFFS CREATED TRIABLE ISSUES OF FACT AS TO WHETHER THE BUSINESS JUDGMENT RULE IS APPLICABLE HERE.

The question here is whether Plaintiffs created triable issues of fact as to State Farm's right to shield its dividend decisions behind the business judgment rule.

Under Illinois law (*see Hill II*, 114 Cal. App. 4th at 450), "[t]he business judgment rule is a presumption that directors of a corporation make business decisions on an informed basis, in good faith, and with the honest belief that the

course taken was in the best interests of the corporation . . .. However, the plaintiff may rebut the presumption by presenting evidence that the director[s] acted fraudulently, illegally, or without becoming sufficiently informed to make an independent business decision." *Ferris Elevator Co., Inc. v. Neffco, Inc.* (1996) 285 Ill. App.3d 350, 354- 355.

"Decisions made without any deliberation are not protected by the business judgment rule." *RSL Communs. PLC v. Bildirici* (S.D.N.Y. Sept. 14, 2006, No. 04-CV-5217), 2006 U.S. Dist. LEXIS 67548, *19; *see also In re RSL COM, Primecall, Inc.* (Bankr. S.D.N.Y., Dec. 11, 2003, Nos. 01-1145 & 01-1146) 2003 Bankr. LEXIS 163, at *40 (allegations that "directors abdicated all responsibility to consider action that was arguably of material importance to the corporation puts directly in question whether the board's decision-making processes were employed in a good faith effort to advance corporate interests."); *Abrams v. Koether* (D.N.J. 1991) 766 F. Supp. 237, 251 ("A director violates the duty of procedural due care to a corporation and its shareholders when the director makes uninformed or nondeliberated decisions on behalf of the corporation.").

Focusing on decisions not to declare dividends, Illinois law withholds business judgment rule protection if "the withholding is fraudulent, oppressive or totally without merit" (*Romanik v. Lurie Home Supply Center, Inc.* (1982) 105 Ill.App.3d 1118, 1134 (quoted in *Hill II*, 114 Cal.App.4th at 450)) or is tainted by "dishonest conduct." *Hall v. Woods* (1927) 325 Ill. 114, 140-141 (quoted in *Hill II*, 114 Cal.App.4th at 450).

But first it must be shown that the Board has acted. The presumption "operates only in the context of director action . . . it has no role where the directors have either abdicated their functions, or absent a conscious decision, failed to act. *Silver v. Allard* (N.D. Ill. 1998) 16 F. Supp. 2d 966, 970. "Where

there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application." *Id.*.

There are triable issues of fact whether the Board actually deliberated or made decisions on management dividend policy, or its specific dividend recommendations; whether the Board was sufficiently informed to make dividend decisions; whether its dividend decisions were totally without merit; and whether the Board made its decisions in bad faith, hiding its disregard for policyholders' rights behind the incomplete and misleading information it provided to them. The summary judgment should therefore have been denied, and, for the same reasons, Plaintiffs' motion for a new trial should have been granted.

A. THE BACKGROUND

1. Mutual Policyholders' Rights To Dividends.

Business judgment does not apply in a vacuum, but in the context of a particular business corporation. The application of the rule, like the application of corporate law in general, may vary with the context. So, for example, the Illinois Business Corporation Act ("BCA") does not apply to insurance companies. *See* 805 ILCS 5/3.05.

Here, as the trial judge put it, the Board "was permitted to operate State Farm in accordance with the general theories underlying operation of a mutual insurance company." *See* Summary Judgment Order ("SJO") (AA-23, 06450-06484), at 7. While "[g]eneral principles of corporate law control the rights of stockholders[,] [t]he rights of policyholders are controlled by their policies of insurance and any applicable statutory provisions." *Ohio State Life Ins. Co. v. Clark* (6th Cir. 1960) 274 F.2d 771, 775. Under Illinois law, "[t]he rights and interests of policyholders in the assets of a mutual life insurance company are contractual in nature and are measured by their policies and by the statutes,

charter, and by-laws, if any, which comprise the terms of their contracts[.]" *Lubin v. Equitable Life Assur. Soc.* (1945) 326 Ill. App. 358, 365.

In a recent decision, *Willmschen v. Board of Directors of the Trinity Lakes Improvement Assoc.* (2005) 362 Ill. App. 3d 546, 551, an Illinois court – following New York law to the effect that "it may be good business judgment to walk away from a contract, [but] this is no defense to a breach of contract claim," *Dinicu v. Groff Studios Corp.* (1999) 257 A.D.2d 218, 223 – warned that the business judgment rule does not justify overriding express contractual obligations.

In *Fe Bland v. Two Trees Management Co.* (1985) 489 N.E.2d 223, 228, the New York Court of Appeals applied that principle to hold that the business judgment rule "constitutes no grant of general or inherent power in the directors to enforce against a shareholder an edict of the directors beyond their authority to make under either the bylaws of the corporation or, in the case of a cooperative apartment corporation, the contract between corporation and its shareholder/lessees embodied in the proprietary lease." The same is true of the contract between a mutual insurance company and its shareholder/policyholders.

As an Illinois mutual company, State Farm is owned, not by shareholders, but by policyholders. *See, e.g., Duffy v. Mutual Benefit Life Ins. Co.* (1926) 272 U.S. 613, 616; 215 ILCS § 5/42(1). Its directors are fiduciaries of the policyholders, *Winger v. Chicago City Bank & Trust Co.* (1946) 394 Ill. 94, 108, who are "entitled to the utmost fidelity of the directors" to their interests. *Johnson v. Central Standard Life Ins. Co.* (1968) 102 Ill.App.2d 15, 27.

The company is "organized, maintained, and operated solely for the benefit of their policyholders[.]" *Hill II*, 114 Cal. App. 4th at 440. Its purpose is not to generate entrepreneurial profits but solely to provide insurance to members at cost. *Id.*

Dividends paid to mutual policyholders are fundamentally different from shareholder dividends. If a shareholder in a stock corporation is not paid a dividend, he receives the equivalent benefit of a rise in the value of his stock reflecting the retention and reinvestment of earnings. But because a policyholder does not own a transferable share in the mutual company, the accumulation of a surplus beyond the needs of the company as an insurer is "not to the interest of present policyholders entitled to insurance at cost." *See Keystone Mut. Casualty Co. v. Driscoll* (W.D. Pa. 1942) 44 F. Supp. 658, 659.

Policyholders receive no benefit from surplus beyond that necessary to ensure that State Farm will meet its responsibilities as an insurance company, and "insureds do not have to pay for what does not give them any benefit whatsoever." *20th Century Ins. Co. v. Garamendi* (1994) 8 Cal. 4th 216, 302.

A mutual insurer must, therefore, provide for "the right of members to the return of premiums which are in excess of the amount needed to cover losses and expenses." *Modern Life & Accident Ins. Co. v. Comm'r* (7th Cir. 1969) 420 F.2d 36, 38. It "may maintain a reasonable reserve for the sole purpose of paying losses . . ., but may not establish a surplus fund for the purpose of making profits on investments." *Thompson v. White River Burial Ass'n* (8th Cir. 1950) 178 F.2d 954, 957-958. As the Eight Circuit ruled in *Thompson*, this does not mean that mutual companies must actually distribute all surplus: "[i]t is enough that the power exists when a surplus of premium receipts over costs of insurance in fact exists; and the determination of the existence of the appropriate surplus is largely within the discretion of those charged with management of the association." 178 F.2d at 957.

Illinois law provides that the Board "may from time to time fix and determine the amount of dividends . . . to be returned to each policyholder, and may for such purpose establish reasonable . . . plans for distribution of such

refunds . . . after retaining sufficient funds for the payment of the company of all outstanding policy and other obligations." 215 ILCS § 5/54(2). The Board must make its dividend distributions from the company's "earned surplus," its net worth exclusive of initial seed capital ("contributed surplus"). 215 ILCS 5/54(3)(a). According to Prof. Coffee, these statutory provisions constitute "an express statutory instruction that the board must find that is has retained sufficient surplus funds to meet all obligations before it pays a dividend or returns premium." AA-11, 03205.

As shown above, these responsibilities, which Illinois law treats as contractual as well as statutory, *Lubin, supra*, 326 Ill. App. at 365, are also reflected in explicit provisions of State Farm's policies and bylaws (which form part of their contract with policyholders). *Ankele v. Workingmen's Relief Soc'y, A. U. V. O.* (1913) 182 Ill. App. 470, 474.

B. THE BOARD NEVER DELIBERATED ON OR MADE A DIVIDEND DECISION OF ITS OWN.

1. There Is A Triable Issue Of Fact Whether The Board Ever Deliberated About Management's "Business Model" Excluding Invested Surplus From Consideration.

State Farm has admitted that its dividends were declared in accordance with "long-standing, overall business model" which placed its entire invested surplus off limits for dividend purposes (Motion at 33:20-25). There is a triable issue of fact as to whether the Board ever deliberated or exercised its discretion on this fundamental dividend policy -- and therefore whether there was any Board decision on the issue of excluding surplus from dividend consideration to which the business judgment rule attaches. The summary judgment must therefore be reversed. *Silver v. Allard, supra*, 16 F. Supp. 2d at 970; *RSL Communs. PLC v.*

Bildirici, supra, 2006 U.S. Dist. LEXIS 67548 at **19-20; *Abrams v. Koether, supra,* 766 F. Supp. at 251.

State Farm's President and Vice-Chairman Vincent Trosino testified categorically that the State Farm Board never once considered returning any portion of the Company's accumulated savings and gains to policyholders:

> Q: And there's never been a time since you've been on the board in which you have considered dividending out any portion of the earnings related to invested surplus.
>
> A: That's right. We have not considered dividending out surplus for the purpose of paying a dividend.

AA-10, 02911–02912.[7]

Instead, there is evidence that State Farm followed an unchanging practice under which policyholders were eligible for dividends only if they lived in a state in which, during the recent policy period under review, policyholders in the aggregate filed fewer claims than anticipated and, in so doing exceeded a management-set "underwriting income target." AA-5, 01362-01363. A 1987 "Memorandum to File" re "Dividends" authored by State Farm's Senior Vice-President Roger Joslin described management's rationale for this "business model":

> [w]hile not prohibited from doing so, we are reluctant to take any action which appears to return investment income to policyholders. Our philosophy has been to return unneeded premium rather than a portion of total profits.

AA-13, 03062–03063.

---

7 State Farm actuary Gregory L. Hayward confirmed that even investment income from the policy period being considered for dividends is excluded. AA-11, 3019

There is no evidence that this policy was ever presented to, deliberated on, or adopted by the Board. There is evidence it was not. AA-10, 02910 – 02912. Board minutes and meeting materials during the Class Period produced by State Farm contain no indication of such consideration. AA-14-16, 3769 – 4447. The corporate record reveals only a management-conceived and implemented "business model" to exclude policyholders from sharing in surplus, no matter what. There is therefore a triable issue of fact as to whether that exclusion was the subject of Board decision subject to the business judgment rule's protection.

2. The Board Did No More Than Rubber-Stamp Management's Dividend Recommendations.

Corporate boards "have fiduciary duties of care and due diligence which require them to do more 'than passively rubber-stamp the decisions of the active managers.'" *Davidowitz v. Edelman* (N.Y. Sup. Ct. 1992) 153 Misc. 2d 853, 857 (quoting *Schmidt v Magnetic Head Corp.* (1984) 101 A.D.2d 268, 281). They may not delegate duties which lie "at the heart of the management of the corporation." *Chapin v. Benwood Foundation, Inc.* (Del. 1979) 402 A.2d 1205, 1210 (*aff'd sub nom. Harrison v. Chapin* (Del. 1980) 415 A.2d 1068). Dividend decisions fall into that category.

In the nine years preceding Plaintiffs' complaint, the Board declared a dividend just six times. DSOF No. 110; AA-12, 03274. There is evidence that on each occasion, management presented the Board with a one page "worksheet" identifying states and amounts of proposed dividends. AA-12, 03271–03274. The Board never considered dividends except when management raised the subject, without regard for State Farm's earnings, savings, investment gains or other surplus. On each occasion, the minutes reveal and testimony establishes that the Board approved management's recommendation without modification, discussion

or consideration of alternatives. AA-13, 3742-3747 (dividend worksheets) & AA-12, 03265; AA-12, 03324.

This is evidence of abdication, not exercise, of Board discretionary responsibility over dividends. Plaintiffs are entitled to have this inference drawn in their favor at the summary judgment stage (*Molko*, *supra*, 46 Cal.3d at 1107), and it creates a triable issue of fact as to whether the business judgment rule applies to protect these decisions.

The dates of the dividends declared during the Class Period (SJO at 4 (AA-23, 06456)) reveal multiple lengthy gaps between dividend deliberations: more than 2½ years between March 1984 and November 1987; 3+ years between November 1988 and December 1991; and more than 2½ years between April 1994 and November 1997. Board minutes and Director Jaedicke confirmed that, in no-dividend years, there simply was no Board discussion of whether surplus levels would allow a dividend. AA-14-16, 3769-4447; AA-12, 03296.

The Board's long gap periods of no-dividend-consideration are especially significant given policyholders' "lapse rate" (the rate at which policyholders' insurance contracts are not renewed for some reason), averaging approximately 14% per annum between 1986 and 1998. *See* State Farm's Response to Plaintiffs' Class Notice Interrogatory No. 8 AA-11, 03045-03048. If the Board fails to deliberate about dividends at regular periods, then policyholders whose policies lapse during the long, no-dividend-consideration gaps will be improperly foreclosed from dividend participation. AA-8, 02037; *see also Coons v. Home Life Ins. Co.* (1938) 368 Ill. 231, 236 ("It is evident that distribution [of mutual policyholder dividends] must be at fixed periods[.]").

The question in this case is whether or not the policy was in force at the time of death of insured. Dividend language is substantially different. Does not seem to be discretion in paying dividends. Dividends by K were to be paid at a specific time.

This evidence of periodic inattention also creates a triable issue of fact as to whether State Farm has forfeited business judgment rule's protection, at least for the long gaps. AA-8, 02045-02406.

The testimony of individual directors and officers regarding the Board's general discussions of the financial health of the company, including its surplus, which apparently satisfied the trial court (SJO at 12, 19 (AA-23, 06464 & 06471)), could not warrant the grant of summary judgment. In the absence of any evidence linking those general discussions to issues of dividend policy, specific dividend decisions, or State Farm's actual surplus needs, that evidence created at most a triable issue of fact as to whether the Board deliberated fundamental dividend issues at all.

3. The Board Never Deliberated About The Purported Provision Of Rate Reductions In Lieu Of Dividends.

The evidence also creates a triable issue of fact as to whether the Board deliberated the management's purported alternative to dividends: the use of surplus to reduce premiums. The trial court concluded that "part of State Farm's strategic plan was to use its surplus to allow lower rates for State Farm policyholders." SJO at 8 (AA-23, 06460 (citing DSOF 92)). However, the Board never deliberated on the topic.

Wendy Gramm, a Board member from 1993-2002, could recall no instance of a written or oral presentation to the Board regarding a rate reduction in lieu of dividends. AA-12, 03383. Gramm's testimony is confirmed by 15 years of Board minutes giving no hint that this issue ever arose at a Board meeting. AA-14-16, 03769-04447. Testimony to contrary from Board Member Trosino (AA-5, 01383-01384) and actuary Hayward (AA-5, 01162-01164) could do no more than create a triable issue of fact on the subject.

Further, both Director Gramm's testimony (AA-12, 03383) and internal memos during the class period (AA-11, 03062-3064 and AA-12, 03392-03393) show that rate reductions were responses to competitive and marketing pressures, not alternatives to dividends as a means of returning excess premium (or the profits from investing excess premium) to policyholders. State Farm's filings with state regulatory agencies regarding their rate reductions, which must disclose all factors relevant to the rate (AA-9, 02500), give no indication that they were intended to return excess surplus to policyholders. AA-12, 03243. They were not based on the level of actual surplus at all, but on the expected future rate of return on a fraction of that surplus. AA-12, 03117-03144.

That, too, is evidence that the issue of distributing surplus through rate cuts rather than dividends was never deliberated.

C. TRIABLE ISSUES OF FACT EXIST WHETHER THE BOARD WAS ADEQUATELY INFORMED IN ITS DELIBERATIONS ON DIVIDENDS.

Management never supplied the Board with the actuarial analysis required for an informed judgment as to State Farm's surplus needs, but instead supplied the Board with fundamentally erroneous information regarding its legal responsibilities to policyholders. Each of those two bodies of evidence independently creates a triable issue of fact as to whether the Board failed "to become sufficiently informed to make an independent decision" regarding dividends. *Hill II*, 114 Cal. App. 4th at 451. Finally, management's misinforming the Board as to the tax consequences of dividends adds further support to the existence of a triable issue of fact on that issue.

1. The Standard For Adequate Information.

Under Illinois law, directors have a "duty to inform themselves of the material facts necessary to exercise their judgment" as part of "the exercise of due care" which is "*a prerequisite to the applicability of the business judgment rule.*"

Stamp v. Touche Ross & Co. (2003) 263 Ill. App. 3d 1010 at 1015, 1016; *Lower v. Lanark Mut. Fire Ins. Co.* (1983) 114 Ill. App. 3d 462, 467. The *Stamp* court based that aspect of the duty of due care on the California case of *Gaillard v. Natomas Co.* (1989) 208 Cal.App.3d 1250, 1264-65, which held that

> [D]irectors may not close their eyes to what is going on about them in corporate business, and must in appropriate circumstances make such reasonable inquiry as an ordinarily prudent person under similar circumstances.

Judge Kuhl found no triable issue of fact on that issue based in part on her assumption that "[t]he deference to decision-making by corporate boards that is inherent in the business judgment rule extends to information gathering and analysis by corporate boards," ruling that the Board could conclude for itself that such analysis was unnecessary. SJO at 15 (AA-23, 06467).

But there was no evidence that the Board ever reached such a conclusion, and *In re RJR Nabisco, Inc. Shareholders Litigatio*n (Del.Ch. Jan. 31, 1989, C.A. No. 10389) 1989 Del.Ch.LEXIS 9, **57-58, upon which Judge Kuhl relied, does not represent Illinois law. In Illinois, the exercise of due care, including being adequately informed, is a prerequisite for the application of the business judgment rule, not vice-versa. *Stamp v. Touche Ross, supra*, 263 Ill. App. 3d 1010, 1016.

2. The Board's Dividend Decisions Could Not Be Adequately Informed Without Knowledge Of State Farm's Actual Surplus Needs And The Level Or Range Of Excess Surplus.

State Farm's own analysis, case law, and Plaintiffs' expert witnesses, all support the conclusion that, in order to decide whether to declare dividends, the Board had to know not only how much surplus State Farm had, but also how much it needed.

The insurance industry distinguishes between "required surplus" – the surplus needed to back up the company's insurance operations – and excess surplus ("surplus surplus"):

> a [casualty insurance] company is required by the regulatory scheme to maintain sufficient surplus to guarantee the integrity of its insurance operations. Such "required surplus" cannot be separated from the insurance business of the company. That portion of surplus not required in insurance operations has been referred to as surplus surplus.

Feit v. Leasco Data Processing Equip. Corp. (E.D.N.Y. 1971) 332 F. Supp. 544, 550.

State Farm in effect has conceded that its Board could not make informed dividend decisions without an actuarial analysis of its surplus needs and the level of its "required surplus," affirming that "[b]efore considering any potential dividend decision, State Farm Mutual's . . . board must determine whether the company's financial strength is sufficient to withstand the many highly uncertain risks it faces" (AA-18, 05136-05137), which determination is "*a uniquely actuarial issue.*" AA-11, 03199 (emphasis added).

The Board of a mutual insurer must exercise its discretion, in good faith and on an informed basis, to determine what the level or range of "required surplus" should be and how much "surplus surplus," if any, should be distributed to policyholders as dividends. *Penn Mut. Life Ins. Co. v. Lederer* (1920) 252 U.S. 523, 525-526 ("It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholder. Some payment to the policyholder representing such excess is ordinarily made by every mutual company *every year*[.]") (emphasis added); *Lipsman v. Reich* (N.Y. Misc. 1939) 173 Misc. 294, 297 ("It cannot be said that the matter of paying a dividend is solely within the unreviewable discretion of the

directors. While the stability and solvency of the mutual company is the prime consideration, the principle of mutuality would be a mere sham, if the directors could, under all circumstances, reserve within the treasury all the accumulation of excess charges. Such procedure, in some cases, would be both unjust to the members and an encouragement to improvidence and arbitrary conduct on the part of the directors[.]"); *Mutual Fire Ins. Co. v. United States* (D. Pa. 1943) 50 F. Supp. 665, 673 (D. Pa. 1943) ("[d]espite the fact that surplus resulted from operations over a long period of years, there has been no distribution to policy holders since 1873. Clearly, the surplus account (designated as a "Contingent Fund") was sufficiently substantial at all times over a long period to permit a distribution to policy holders had the plaintiff operated on the principle that insurance should be furnished at cost. The reserves maintained are patently far in excess of what would be required to meet probable losses.").

The testimony of Plaintiffs' actuarial expert, Mr. Toothman, and of Plaintiffs' corporate governance expert, Prof. Bebchuk – the Director of Harvard Law School's Corporate Governance Program – further support the conclusion that such analysis is necessary to an informed dividend decision.

According to Prof. Bebchuk, a mutual company must provide insurance at "an effective price that does not exceed the insurer's costs of covering insurance payments and continuing to maintain surplus at adequate levels." In order to do so, it must deliberate in an informed manner about its actual surplus needs and whether the surplus is sufficiently robust to permit the issuance of dividends to policyholders at regular intervals. AA-8, 02035-02036. That means, of course, that deciding whether and how much to distribute to the policyholders requires a determination of the level of "excess surplus," if any, and,

> [b]y definition, to determine whether excess surplus existed . . . required . . . two preliminary determinations: (i) determine what surplus State Farm had at the given point in time; and (ii) determine the minimum level of surplus that was adequate for State farm to have at the given point in time taking into account the risks State Farm faced.

AA-8, 02039.

Plaintiffs' actuarial expert Toothman agreed that:

> [i]n order for State Farm's Board of Directors to make an informed decision related to the declaration of a dividend, and the amount of dividend declared, they needed to have an assessment of appropriate surplus for the Company.

AA-9, 02496.[8]

The trial court disagreed, asserting that Plaintiffs' argument "merely criticizes the decisions made by the Board of Directors in light of other possible analyses" (SJO at 9 (AA-23, 06461)), and was "premised on the incorrect notion that the State Farm Board was required to accept the relevance of those concepts." SJO at 16 (AA-23, 06468). In support of that conclusion, the trial court quoted this Court's statement that "[i]t is impossible to specify the 'right' amount of [surplus] for most insurers through a formula." *Hill II*, 114 Cal.App.4th at 441.

The trial court missed the point.

An analysis of surplus needs to determine the level of required surplus is not just one among many "possible analyses." It forms the appropriate foundation for *any* analysis. Even State Farm has conceded that its "board must determine whether the company's financial strength is sufficient to withstand the many

---

[8] Though the trial court found Toothman unqualified to testify as to State Farm's surplus needs (SJO at 16-17 (AA-23, 06468-06469), that decision was erroneous.

highly uncertain risks it faces" before it declares dividends (AA-18, 05136-05137), and that this determination presents a "uniquely actuarial issue." AA-11, 03199. If State Farm's Board wished to employ another means of analysis, it presumably could have done so. It did not. It never considered the issue.

There is, therefore, at least a triable issue of fact as to whether the Board required an actuarial or some other analysis of State Farm's actual surplus needs to make an informed dividend decision.

Nor is it true that Plaintiffs seek to impose a particular "formula" for the "right" amount of surplus, to have a jury establish a surplus "maximum," or to compel State Farm to disgorge all of its excess surplus to policyholders. Even in a mutual company "the determination of the existence of the appropriate surplus is largely within the discretion of those charged with the management of the association." *Thompson, supra*, 178 F.2d at 957. Plaintiffs' point here is only that the Board could not make informed dividend decisions without first determining an appropriate range of required surplus based on an actuarial or other analysis of State Farm's actual surplus needs. The precise level or range of required surplus was within the Board's discretion, and the exercise of that discretion, if the product of properly informed deliberation, has the protection of the business judgment rule.

3. The Board Had Inadequate Information About State Farm's Surplus Needs And The Level Of Its Excess Surplus.

a) State Farm's Own Evidence Creates A Triable Issue Whether There Was Adequate Information.

Although State Farm's directors received reports on the various categories of State Farm's surplus (SJO at 11 (AA-23, 06463)), there is also evidence that

they never received any analysis of the level of surplus the company needed at any given time. Nor did they deliberate on the subject.

Specifically, State Farm's Chief actuary Gary Grant testified that State Farm's actuaries never analyzed or expressed an opinion to manageFment or the Board about whether State Farm had adequate surplus to cover its risks and needs. AA-12, 03231–03237. One of the actuaries working under Grant testified that he did a surplus needs analysis during the Class Period but that this analysis was not put into writing until after the Class Period, a year after this case was filed. AA-11, 03007; *see also* AA-12, 03231–03237.

Director James Wilson testified that the Board did not discuss what amount of surplus was appropriate (AA-12, 03325), Director Wendy Gramm testified that she could not recall any presentation to the Board as to the inadequacy of the surplus (AA-12, 03380), Director Trosino testified that the Board never asked for nor received an analysis of whether State Farm could afford a dividend in 1995 or 1996 (two years in which State Farm's surplus skyrocketed, but the Board did not deliberate on dividends) (AA-10, 02899), and Director Jaedicke testified that he could not recall any Board discussion of whether surplus levels were sufficient to allow a dividend in those years in which a dividend was not declared (e.g, between the 1994 and 1997 dividends). AA-12, 03296.

Although there is testimony from some directors stating their individual belief that State Farm never had too much surplus (AA-12, 03325; AA-12, 03285; AA-5, 01380), the absence of *Board* analysis, discussion, or deliberation makes that testimony irrelevant. Director Gramm testified that she could not recall any presentation by management indicating that surplus was inadequate. AA-12, 03380 & 03375. Even Director Wilson conceded that that Board never discussed what amount of surplus was appropriate. AA-12, 03325–03326. "Under the business judgment rule there is no protection for unadvised or unintelligent

judgment." *Holland v. Stenhouse* (N.D. Ill. Mar 1, 1991, No. 87-C-3086) 1991 U.S. Dist. LEXIS 2518, *12.

In the verified Petition that resulted in this Court's *Hill II* opinion (*see* Appellants' Motion for Judicial Notice, Ex. 1), State Farm asserted that its "board of directors meets to determine matters of internal corporate governance, including whether the company's surplus is sufficient and whether, when, and how much it should distribute to policyholders in dividends." *See* Petition at 12, ¶ 1. The record below demonstrates, however, that the Board never considered the sufficiency of surplus to satisfy "all outstanding policy and other obligations"; it was never supplied with the "uniquely actuarial" analysis necessary to do so; and it never considered surplus as a source of dividends.

b) Plaintiffs' Experts Further Support The Existence Of A Triable Issue, But Their Testimony Was Wrongfully Disregarded By The Trial Court.

The declarations of Plaintiffs' two experts, Mr. Toothman and Prof. Bebchuk, also support the conclusion that the Board was inadequately informed in its dividend decisions, made dividend decisions that were totally without merit, and acted dishonestly and in bad faith.

1) Toothman's Testimony Should Not Have Been Excluded.

Mr. Toothman testified that the Board needed an actuarial analysis of the appropriate level of surplus in order to make adequately informed dividend decisions, and that no such analysis was performed. AA-9, 02496-02499.

Mr. Toothman is a Fellow of the Casualty Actuarial Society, a Member of the American Academy of Actuaries, a Fellow of the Conference of Consulting Actuaries, and a Fellow of the Canadian Institute of Actuaries. He is a past President of both the Casualty Actuarial Society ("CAS") and the Conference of

Consulting Actuaries and former Vice President of the American Academy of Actuaries. He also sat on the Board of Directors of all three organizations. He is Vice Chairman of the International Association of Consulting Actuaries. He served for sixteen years in various positions on the CAS Examination Committee, responsible for education and instruction of property/casualty actuaries in the United States, including four years as the Vice President responsible for all education and examination processes of the CAS. For nine years, he was Managing Partner of Arthur Andersen's Property/Casualty Consulting Group. He has decades of practical, hands-on industry expertise, having been employed for 11 years at Aetna Insurance Company, Great American Insurance Company and Great American Surplus Lines Company, and providing actuarial consulting services to numerous other insurance companies and state regulatory agencies.

Despite these credentials, the trial court found Mr. Toothman unqualified on these issues, because there was no evidence that he had experience in determining the appropriate level of surplus for a mutual company, or had written an article in a recognized journal on the subject, or advised a mutual company or consulted with its board on the issue, or himself served on the board of mutual company. The trial judge noted specifically that Mr. Toothman testified in his deposition that he could not recall having consulted with a mutual company regarding surplus needs analysis. SJO at 16-17 (AA-23, 06468-06469). The trial court abused its discretion. *Jeffer, Mangels & Butler v. Glickman* (1991) 234 Cal. App. 3d 1432, 1443; *Alef v. Alta Bates Hospital* (1992) 5 Cal.App.4th 208, 218.

In *Jeffer*, a legal malpractice action, the question was whether the plaintiff's expert was qualified to give an opinion on a de novo application to form a new savings and loan. The trial court, while conceding that he had a "huge amount of experience" in the savings and loan field, found him unqualified because he had

never filed a *de novo* application which was approved. 234 Cal.App.3d 1432, 1437.

The *Jeffer* court found an abuse of discretion and reversed. 234 Cal.App.3d 1432, 1443. The "threshold test" for determining qualifications is whether "the witness has sufficient skill or experience in the field so his testimony would be likely to assist the jury in the search for the truth." That test was satisfied by his general experience with savings and loan law. The fact that he had not "processed a de novo application through to completion goes to the weight of his testimony, not its admissibility." 234 Cal.App.3d at 1442, 1444.

The *Jeffer* court drew its broad approach to expert qualification from a California Supreme Court decision regarding the qualifications of a physician, *Brown v. Colm* (1974) 11 Cal. 3d 639, 643. The *Jeffer* court found that case involving medical expertise relevant to legal expertise because "both are professions." 234 Cal.App.3d at 1441. Actuaries are also professionals. Mr. Toothman was a professional whose background showed him to have extensive experience in the general area for which expertise was required.

In fact, Mr. Toothman's testimony indicated that he had experience very close to that the trial court insisted upon. He testified that he had "consulted with companies on adequacy of surplus and – and capitalization needs" (AA-16, 04558), and that, though he could not specifically recall dealing with mutual companies, he could "think of multiple instances where the policyholders were, in essence, the owners of the company, but I don't recall the legal structure of those firms" (AA-16, 04558-04559), and that he advised the board of directors of insurance companies regarding a surplus needs analysis in start-up situations. AA-16, 04564.

Given his extensive record of experience with the actuarial analysis of surplus in general, his knowledge of the law governing mutual companies, his specific experiences with insurance company surplus needs and his experience with firms which, whether they were technically mutual companies or not, had the same structure as mutual companies, Mr. Toothman was no more disqualified by a lack of evidence of experience specifically with the surplus needs of mutual companies than was the expert in *Jeffer* by his lack of experience with getting a de novo application approved.

No reasonable jurist could conclude that he did not meet the "threshold test" of "sufficient skill or experience in the field so his testimony would be likely to assist the jury in the search for the truth" regarding the surplus needs of mutual insurance carriers. 234 Cal.App.3d at 1442.

> The trial court will be deemed to have abused its discretion if the witness has disclosed sufficient knowledge of the subject to entitle his opinion to go before the jury.

Alef v. Alta Bates Hospital, supra, 5 Cal.App.4th at 219.

2) The Trial Court Erred In Reading Bebchuk's Declaration Too Narrowly.

The trial court also found that the declaration of Plaintiffs' governance expert, Professor Bebchuk, did not create a triable issue of fact, because he "was unwilling to opine that State Farm's Board had inadequate information from which to assess State Farm's surplus." SJO at 18 (AA-23, 06470). The trial court focused on Bebchuk's comment (in para. 29), that "[w]ithout receiving adequate information and adequate input from expert staff, it is *doubtful* that the directors would have been able to make adequate determination of the needed level of surplus by themselves even with substantial deliberation and time investment." SJO at 10 (AA-23, 06470) (emphasis added by trial court). AA-8, 02041-02042.

The declarations supporting a plaintiff's opposition to summary judgment must be construed in plaintiff's favor. *Gafcon, Inc. v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388, 1402. The trial court breached that rule in its reading of Bebchuk's declaration, focusing only on the word "doubtful," in that one statement, and ignoring other, unequivocal, statements.

So, for example, Bebchuk stated in paragraph 21 that the dividend decisions, "if they were in fact made by the Board, were made without information and investigation." AA-8, 02039. Further, Bebchuk stated in paragraph 24 that "the Board received little information, and was insufficiently informed, about the minimum necessary level of surplus and whether State Farm's surplus exceeded it." AA-8, 02040.

Reading the declaration broadly in Plaintiffs favor, as it must be read, those two unequivocal statements dispel any qualification that might otherwise arise from the use of the word "doubtful" in paragraph 29. The Bebchuk declaration raises triable issues of fact, and that is an independent reason for reversing the summary judgment.[9]

4. Board Members Were Misinformed About Their Fundamental Legal Responsibilities.

In explaining the duties of a State Farm director to Director Jaedicke, for example, management provided him with section 8.85 of the Illinois Business Corporation Act (adopted in 1985). *See* AA-12, 03259 – 03260, 03282.

---

[9] Any conceivable lack of clarity in Prof. Bebchuk's opinion based upon his use of the word "doubtful" -- which in all events was required to be resolved in Plaintiffs' favor -- was dispelled by Prof. Bebchuk's declaration in support of Plaintiffs' new trial motion. AA-23, 06552-06557. *See Tortorella v. Castro* (2006) 140 Cal. App. 4th 1, 7 (a party seeking a new trial following summary judgment may offer a clarifying, supplemental declaration from an expert witness).

Section 8.85 is a "corporate constituency statute" that permits directors of Illinois stock corporations to "consider the effects of any action . . . upon employees, suppliers and customers of the corporation or its subsidiaries . . .." *See* 805 ILCS 5/8.85. According to State Farm's corporate governance expert Coffee, the statute would give Board members the understanding that they were authorized "to treat shareholders as one of several constituencies and not the primary constituency." AA-11, 03205. As an example, Prof. Coffee commented that the statute required the Board to consider the interests of State Farm Fire and Casualty policyholders along with those of its own policyholders in deciding to make a capital transfer of $3 billion to State Farm and Casualty in 1993, because they were the "customers" of a subsidiary. AA-11, 03203.

That was Director Jaedicke's understanding. He believed that, as a director, he should consider the interests, not only of the policyholders, but of "a number of other constituencies," including "the communities in which you do business and employees." AA-12, 03260. Jaedicke had reread the statute to guide him as to what factors in consider in deciding on the 1993 capital transfer to State Farm Fire and Casualty. AA-12, 03280.

But the Illinois Business Corporation Act (BCA) (of which section 8.85 is a part) does not apply to insurance companies. "Corporations for profit may be organized under this Act for any lawful purpose or purposes, *except for the purpose of banking or insurance*." *See* 805 ILCS 5/3.05 (emphasis added). Insurance companies are excluded because "[t]hey conduct a business charged with the public interest and are authorized and governed by a special act, more stringent in its regulations by reason of the nature of their business." *Doggett v. North American Life Ins. Co.* (1947) 396 Ill. 354, 362.

As State Farm is a mutual insurance company, its directors' orientation must be just the opposite of that provided by section 8.85. "Mutual insurance companies are organized, maintained, and operated solely for the benefit of their policyholders." *Hill II, supra*, 114 Cal. App. 4th at 440. Policyholders are "entitled to the utmost fidelity of the directors" to their interests. *Johnson v. Central Standard Life Ins. Co., supra*, 102 Ill.App.2d at 27.[10] In providing section 8.85 to any of its Board members, therefore, management misinformed them on the heart of their responsibilities, giving them a fundamentally wrong orientation to every issue coming before the Board.

Not knowing that their dividend decisions should serve *only* policyholders' interests in receiving secure insurance protection at cost, at least some members of the Board were deprived of the compass which should have guided those decisions. Mistaken about its applicability, Professor Coffee claimed that section 8.85 supposedly empowered the Board to "balance the interests of shareholders with those of other constituencies, including employees and local communities," thereby making it "unreasonable to deem the board's power to declare dividends to be subject to any obligation to satisfy the shareholders' [sic] reasonable expectations." AA-11, 03204

---

[10] Indeed, one of the characteristics of a mutual corporation is that the members (policyholders) should have "the right... to choose management," *National Chiropractic Insurance Co. v. United States* (8th Cir.1974), 494 F.2d 332 at 333, so that they can compel the payment of dividends "at any time by virtue of their absolute control of the company." 494 F.2d at 334. Because the Board amended the bylaws to eliminate any such control here (AA-8, 02062-02063 & AA-8, 02163-02168), this Court's assistance is vital to policyholders. *See Hilton Hotels Corp. v. ITT Corp.* (D. Nev. 1997) 978 F. Supp. 1342, 1351 ("[O]ne of the justifications for the business judgment rule's insulation of directors from liability for almost all of their decisions is that unhappy shareholders can always vote the directors out of office.").

That misorientation in itself made it impossible for the Board's dividend decisions to be adequately informed.

5. Board Members Were Ignorant Of The Tax Consequences Of Declaring Dividends.

Finally, the Board's lack of information needed for dividend decisions is illustrated by members' erroneous belief that State Farm's enormous stock portfolio was "off limits" as a source of dividends because the sale of any stocks with imbedded gains would result in substantial capital gains taxes. *See* AA-12, 03287; AA-5, 01164.

In fact, Plaintiffs' insurance tax expert, Mr. Michiels, testified that State Farm would incur *no taxes* from any sale of stock to pay dividends, and instead would likely obtain a tax benefit. AA-8, 02296-02297.

D. PLAINTIFFS' EVIDENCE CREATES TRIABLE ISSUES OF FACT WHETHER THE BOARD'S DIVIDEND DECISIONS WERE TOTALLY WITHOUT MERIT.

There are also a triable issues of fact as to whether the Board's dividend decisions suffered from a "total lack of merit." *Hill II*, 114 Cal. App. 4th at 451.

1. Because The Board's Dividend Decisions Were Uninformed And Undeliberated They Also Were Totally Without Merit

In its evaluation of the "totally without merit" issue, the trial court was satisfied to conclude that, in the abstract, the Board could have had "several meritorious rationales" to justify the limitless accumulation of surplus and refusal to consider using any of it to fund dividends. The court mentioned two: State Farm's need for rainy-day capital since it cannot sell equity; and State Farm's purported "strategic plan" to use surplus to subsidize lower insurance rates. SJO at 7-8 (AA-23, 06459-06460).

The trial court disregarded the issue of whether the Board was insufficiently informed as a basis for finding the decisions "totally without merit," believing, incorrectly, that the "totally without merit" exception is not concerned with the decision-making process, but only whether the results were irrational. SJO at 11, n.3 (AA-23, 06463).

However, *Barnes v. State Farm Mut. Auto. Ins. Co.* (1993) 16 Cal. App. 4th 365, 380 n. 14, addressing the rule's application to the dividend decisions of State Farm's Board under both California and Illinois law, held that to overcome the business judgment rule, "[t]here must be a showing of facts that would set forth, and not just in a conclusory way . . . *a lack of merit in the manner in which their work is performed.*" (Emphasis added.)

The record here creates a triable issue of fact as to whether both the decisional process -- rubber-stamping management's dividend decisions without informed deliberations about management's dividend policy or whether State Farm's surplus was sufficiently robust to permit larger or more frequent dividends -- and its outcome -- a total and permanent exclusion of policyholders from sharing in the savings and gains of the company during the Class Period – were arbitrary and wholly without merit. The evidence of the deficiencies in the process have already been presented. What follows is the evidence that the outcome was also without merit.

2. Triable Issues Of Fact Exist As To Whether The Board's Dividend Decisions Were "Totally Without Merit" In Substance.

As stated by Professor Bebchuk, "State Farm's Board made several decisions and determinations that *fell completely outside the range of reasonableness* and are entirely without merit." AA-8, 02046 (emphasis added).)

The standard for rationality here is that provided by "the general theories underlying operation of a mutual insurance company." SJO at 7 (AA-23, 06459). A mutual insurer must operate solely for the benefit of the policyholders, and seek, not to make entrepreneurial profit, but "to meet their obligations at the lowest possible cost to the policyholders." *Id.* Further, it must honor "the right of members to the return of premiums which are in excess of the amount needed to cover losses and expenses," *Modern Life & Accident Ins. Co. v. Comm'r, supra*, 420 F.2d 36, 38, and "may not establish a surplus fund for the purpose of making profits on investments." *Thompson, supra*, 178 F.2d 954, 957-958.

There is evidence creating triable issues of fact as to whether the dividend decisions were completely without merit on a number of grounds:

(a) there was evidence that the policy of severing policyholders from participation in the company's surplus was arbitrary and irrational;

(b) there was evidence that State Farm's claim to having met its obligations to policyholders by returning surplus in the form of lower rates was false, and could not be justified as meeting those obligations in any case;

(c) there is evidence that State Farm's surplus is excessive by *any* reasonable standard; and

(d) there is evidence that the dividend decisions actually made were erratic and inconsistent by any reasonable standard.

a) Evidence Regarding Management's Policy Of Declaring Dividends Solely On The Basis Of A Portion Of Underwriting Gains And Never From Surplus.

The irrationality identified by Professor Bebchuk inheres in the "business model" of limiting dividends to management-determined portions of a given period's underwriting return by state, while excluding from consideration all other accumulated gains, including investment profit, that comprise the company's

massive surplus. He illustrated his point with a simple example. Under State Farm's "business model," if in a given period it made a $50 million profit in its investment portfolio but no underwriting profit, policyholders would be ineligible for dividends; but if State Farm made a $50 million underwriting profit and no investment profit, they might (but not always) receive some portion of that profit as dividends. That difference in treatment cannot be justified. AA-8, 02051-02055.

There is some evidence suggesting an explanation for the practice, but not one that can justify it: testimony from State Farm actuary Hayward suggesting that the policy was adopted just because it was easier for staff to administer. AA-11, 03019.

Assuming that staff convenience is the basis for the practice, it is not a rational basis for a policy barring the Board from even considering the vast bulk of State Farm's profits as a source of funds with which to meet its obligations to its paramount constituency, the mutual policyholders.

Management will always be strongly inclined to accumulate surplus unless it receives specific directives from the Board to do otherwise. By leaving the discretion with management, the Board was effectively prevented from exercising its basic responsibility.

b) Evidence Regarding State Farm's Being Unable to Raise Capital And Having Met Its Responsibilities By Reducing Premium Rates.

The trial court accepted, as undisputed, State Farm's claim that it could not raise capital in the stock market and used surplus to lower premium rates. SJO at 10 (AA-23, 06462). There was conflicting evidence on both issues.

1) Inability to Raise Capital in the Stock Market.

State Farm argued that it cannot raise money in the stock market, so that it must raise capital through retained earnings. SJO at 10 (AA-23-06462). That ignores the bond market. State Farm's own actuarial expert testified, on the contrary, that a mutual insurer is as free to sell surplus notes as any other insurer, and that State Farm could have raised money, if necessary, by selling all or part of one of its wholly-owned subsidiaries. AA-13, 03753.

2) Providing Rate Reductions In Lieu Of Dividends

The only evidence State Farm presents for this argument was generated after the class period, *and* after this case was filed. All of the pre-litigaion evidence points in the other direction.

State Farm's evidence consists of an internal memorandum *from 2000*, dealing with rate reductions since 1997, including only the last year of the 15-year Class Period (AA-4, 01024-01028), and declarations and deposition testimony given by Trosino, Joslin, Wilson, Jaedicke, and Hayward which prominently feature a reduction, "beginning in 1998," of "its target underwriting return for ratemaking purposes to *negative* five percent." *See, e.g.,* AA-5, 01364-01365.

The evidence from the pre-litigation, Class Period creates a different picture. First, there is no evidence that any such proposal to reduce rates as an alternative to distributing surplus to Policyholders as dividends was ever put before or discussed by the Board. AA-12, 03383.

Internal memos from the class period (AA-11, 03063 and AA-12, 03392) show that rate reductions were responses to competitive and marketing pressures, and the rate filings regarding the 1998 reduction show that it was based, not on the

level of actual surplus, but on the expected future rate of return on a fraction of that surplus. AA-11, 03121 & 03136.

In sum, the evidence creates a triable issue of fact as to whether State Farm's claim that it lowered rates during the class period as an alternative means of returning surplus generated from excess premium to the Policyholders was an opportunistic, *post hoc* rationalization, supported by material generated for that purpose since the litigation began.

c) The Actual Level Of Surplus Could Not Be Justified By Any Measure.

Policyholders have presented evidence creating triable issues of fact as to whether the Board's decisions on dividends and surplus were completely without merit because State Farm's surplus grew to excessive levels by *any* reasonable standard during the class period, while dividends remained at a very low level.

The standard method for determining the appropriate level of surplus compares net premiums to surplus. A former State Farm director represented to Congress that a 3:1 ratio of net premiums to surplus is "safe," and described a "2:1" ratio as "conservative," or even "highly conservative." AA-11, 03183.

State Farm itself, in regulatory filings, described the 2:1 ratio premium to surplus as "prudent taking into consideration the kinds of risks that [its] surplus is intended to withstand[]." AA-11, 03135.

In its 1984 Annual Report, State Farm stated that "our surplus to protect policyholders showed a sizeable increase," so that it was "in a position to continue meeting whatever contingencies may arise . . . whether they be natural disasters, unforeseen judicial decisions or legislative action." AA-13, 03503.

But State Farm's surplus grew dramatically as compared to premiums from 1984 to 1998. While surplus more than quadrupled (growing by $41 billion, or 463%), net premium did not even double (growing by $23 billion, or 193%). AA-9, 02513-02514. Meanwhile, during that same period, State Farm distributed only $2.8 billion in dividends. *Id.*

According to Mr. Toothman, given that growth, it would be "unreasonable to conclude both that 1984's surplus was strong enough to withstand 'any contingencies that may arise,' and that 1998's surplus was not excessive." AA-9, 02514.

There is evidence that, as early as 1985, State Farm itself acknowledged that "message seems to be that we've grown too big for our own good" (AA-12, 03208), and that the steady increase of surplus beyond the 2:1 premium-to-surplus ratio had "caused some to question whether State Farm has 'surplus' surplus." AA-12, 03209. That questioning led State Farm's actuaries to consider readjusting their standard for surplus, first suggesting a ratio of premiums to surplus of only 1.33:1, and then at 1:1. AA-12, 03213 - 03227

State Farm's 1998 surplus far exceeded even those standards. Judged by the 2:1 ratio, State Farm had a "surplus surplus" exceeding $32 billion. Judged even by the 1:1 ratio, the "surplus surplus" exceeded $14 billion.[11] AA-9, 02503 and AA-9, 02519.

The NAIC has another set of norms for surplus, called "RBC" standards. Those standards set the level of insurers' surplus depending on the absolute size of their assets, on the assumption that insurers with larger assets need proportionally

---

[11] In a 1991 memorandum, State Farm actuaries Grant and Dale Nelson reviewed a study indicating that the odds of insolvency were somewhere between *1 in 26 billion* and *1 in 700 quintillion* if State Farm reached a premium-to-surplus ratio of 1:1. AA-13, 03666-03667.

less surplus than those with smaller assets. *See* Brian K. Atchinson, The NAIC's Risk-Based Capital System, 2 NAIC RESEARCH Q.1 (Oct. 1996).

By the NAIC's RBC standards as well, State Farm's surplus was grossly excessive. Though State Farm was at the high end of NAIC's category of the largest carriers by asset size – State Farm had $44.5 billion in admitted assets in 1998, and NAIC's threshold for the largest-size carriers was $10 billion – publicly-available information published by the NAIC shows that State Farm's RBC ratio in 1998 (over 829%) was higher than that set for the category of carriers with only $25 million in assets (799%). AA-10, 02666-02668 and 02685.

State Farm presented the testimony of individual directors who did not believe that the surplus was excessive, including Director Wilson's statement that State Farm had never during his tenure "been in a position where we had too much" net worth, and, if anything felt there was too little, and Director Jaedicke's that the Board was never concerned during his tenure that there was too much. *See* SJO at 8 (AA-23, 06477) (citing testimony).

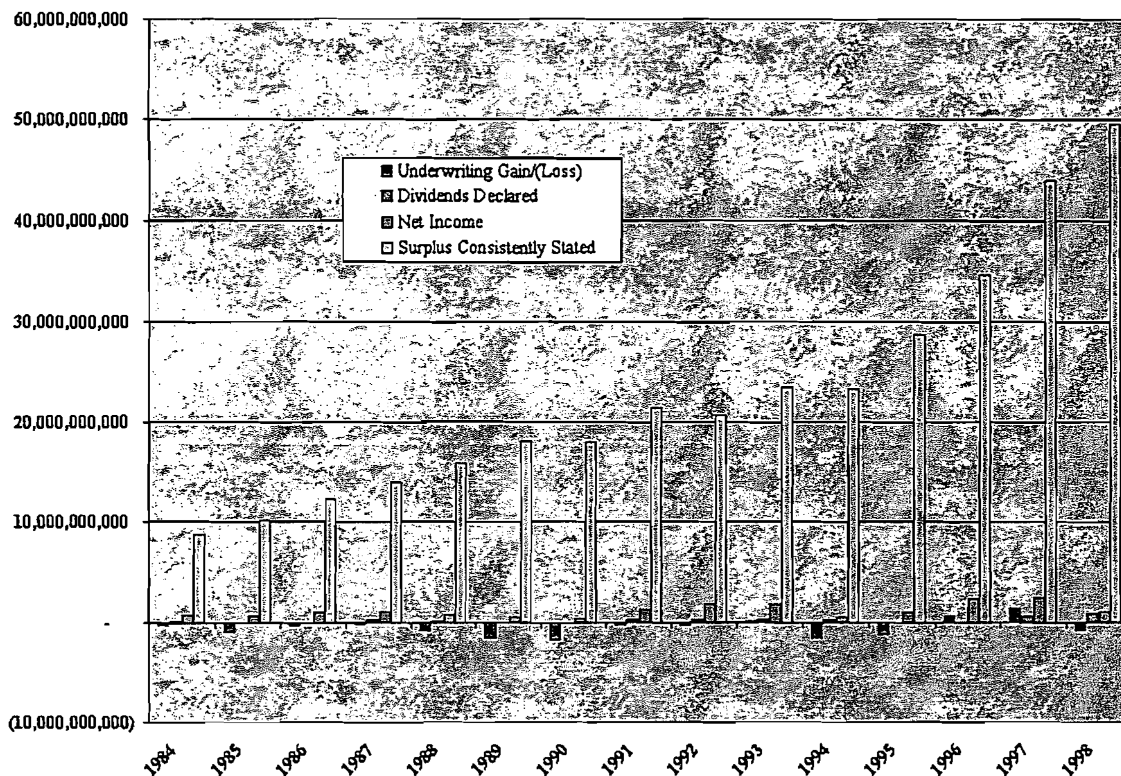
But these evidently ill-informed statements of subjective belief from individual directors, never shared with other Board members and not supported by any analysis, cannot settle the matter.

d) Evidence That State Farm's Dividend Decisions Were Erratic And Inconsistent By Any Standard.

The evidence also creates a triable issue of fact as to whether State Farm's specific dividend determinations were inconsistent and erratic by any standard. Whether measured by state-by-state underwriting performance, total income, premium-to-surplus ratios, or risk-based capital ratios, a review of Board's dividend declarations in relation to the company's financial performance during the Class Period reveals fundamental inconsistencies and contradictions in

dividend actions incompatible with reasoned decision-making. AA-10, 02801 & 02816; AA-8, 02046–02051.

The chart below graphically illustrates State Farm's dividend payments from 1984 through 1998 in relation to underwriting results, net income, and surplus:



The Board failed to consider declaring dividends between March 1984 and November 1987 (2 ½ years), between November 1998 and December 1991 (3 years), and between April 1994 and November 1997, because management did not raise the subject. *See* AA-12, 03258; AA-10, 02898-02899 (no written analysis whether State Farm could afford a dividend in 1995 or 1996 – two years in which State Farm did not issue a dividend).

According to Prof. Bebchuk, the failure to consider dividends in 1995 and 1996 was inconsistent with the decisions to declare dividends in each of the four

years 1991-1994, when the relative surplus was substantially lower than in 1995 and 1996. AA-8, 02045-02046.

E. TRIABLE ISSUES OF FACT EXIST WHETHER THE BOARD'S WITHHOLDING OF DIVIDENDS WAS DISHONEST OR FRAUDULENT.

The business judgment rule is also rendered inapplicable by evidence that the State Farm Board acted deceptively or fraudulently in dividend decisions. *Hill II*, 114 Cal. App. at 449-450 (business judgment rule inapplicable in the face of "dishonest conduct" by the directors (citing *Hall v. Woods* (1927) 325 Ill. 114, 140-141).

Plaintiffs' evidence detailed a long-standing course of deceptive communications from State Farm to policyholders about dividends and surplus: the failure to disclose the "business model" that excluded surplus from dividend consideration, and comprehensively deceptive Annual Reports that consistently concealed, diminished and downplayed the surplus. That evidence creates a triable issue of fact as to whether the Board engaged in or countenanced deceit of the Policyholders as to dividend decisions stripping those decisions of business judgment rule protection.

In *Hill I*, this Court found Plaintiffs' allegations that State Farm Board withheld dividends by overstating underwriting losses, understating income, and falsely claiming that the surplus was required to cover the obligations of affiliated insurance companies sufficient to state a claim of bad faith rebutting the business judgment rule. *See Hill I* at 7. So, too, in *Hill II*, 114 Cal. App. 4th at 450, citing *Romanik v. Lurie Home Supply Center, Inc.* (1982) 105 Ill. App. 3d 1118, 1134, this court found that the Illinois business judgment rule would not protect dividends decision made fraudulently or dishonestly.

The trial court assumed that there is bad faith only when Directors act corruptly in their own self-interest. SJO at 23-24 (AA-23, 06475-06476). But while the cases the trial court cites evidence such corruption, there is nothing in them, or in *Hill II*, 114 Cal. App. 4th at 450, 449-450, or *Romanik*, 105 Ill. App. 3d at 1134, which justifies regarding it as necessary for a finding of bad faith.

On the contrary, as the trial court itself pointed out, the Delaware court, in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (Del. 1986) 506 A.2d 173, 180, held that the business judgment rules requires that directors act "in good faith and in the honest belief that the action taken was in the best interests of the company." The Board's actions in concealing and falsifying the true nature of its dividend decisions and the size of the surplus in its Annual Reports violate that standard.

1. The Board's Failure To Disclose Management's Dividend Policy To Policyholders Was Evidence Of Bad Faith.

Policyholders are entitled to know the actual dividend policies and practices that are followed by management and the Board. *Winger v. Richards-Wilcox Mfg. Co.* (1961) 33 Ill. App. 2d 115, 126-127; 3A Fletcher, CYCLOPEDIA CORPORATIONS § 837.70, at 186-187 (1975) (directors have a duty "to reveal all facts material to corporate transactions, especially with regard to membership corporations," which duty of disclosure "apples to matters of corporate governance as well[.] ").

Here, State Farm's policies and bylaws represented to policyholders that its Board would consider dividends from its "earnings," "savings" and "gains" in a "proper, just, and equitable" manner. *See supra*, § III.A. When the Board declared dividends, State Farm told policyholders it "put [their] interests first" (AA-11, 02967), a message repeated to regulators. AA-11, 02969.

where does this come from?

But State Farm concealed from policyholders the fact that it limited dividends to a narrow subset of current operating income and excluded State Farm's vast surplus from dividend consideration. That nondisclosure provided policyholders with a materially misleading picture of their dividend prospects (AA-8, 02060 - 02061), creating a triable issue of fact as to whether State Farm was acting in bad faith.

The trial court gave two reasons for finding no triable issue on this question, neither of which justifies its conclusion.

First, the trial court found that the Board could not have concealed the no-dividends-from-surplus policy, because there was no evidence that the Board adopted that policy, citing Wilson's comment that there could in principle be "too much net worth." SJO at 25 (AA-23, 06477).

Of course, the Board made no such policy decision; but that does not get State Farm off the hook. The fact that State Farm operated under this policy without the benefit of Board consideration or adoption is another reason for denying it business judgment rule protection.

But the trial court went beyond that to assert that there was no evidence that State Farm ever operated under such a policy, as shown by the fact that in 2000, several years after the end of the Class Period (and after the complaint in this case had been filed) State Farm declared a dividend in a total amount far larger than its underwriting gain that year. SJO at 25 (AA-23, 06477). Such post-Class Period, post-complaint conduct cannot negate the existence of a triable issue as to what happened during the Class Period.

Second, the trial court was satisfied that State Farm did in fact disclose the no-dividends-from-surplus policy to Policyholders when it accompanied dividend payments with the statement that "[t]he dividend reflects better-than-anticipated claims experience in those states." SJO at 25 n.7 (AA-23, 06477).

That evidence did not negate the existence of a triable issue regarding disclosure. In reviewing a summary judgment, this Court will "view the evidence in a light favorable to the losing parties. . ., liberally construing their evidentiary submission while strictly scrutinizing the prevailing parties' evidence." *Manderville v. PCG & S Group, Inc.* (2007) 146 Cal.App.4th 1486, 1496.

Because the purported disclosure says only that this dividend represents "better-than-anticipated claims experience in those states," and does explicitly not reveal that such experience is the *only* basis for declaring dividends, it would have to be liberally construed in State Farm's favor to make it the basis for the inference. Such a construction cannot be given to it for summary judgment purposes, a triable issue of fact remains.

2. The Board's Annual Reports To Policyholders Were Materially Misleading.

Once a year State Farm sends policyholders an envelope insert that contains a brief table that purports to summarize State Farm's "Statement of Condition" (*i.e.*, its balance sheet) and Operating Data (*i.e.*, income and expenses). AA-13, 03503 - 03534. Those are the only official communications from the Board to policyholders on the financial condition of the company, including the total amount of surplus and the amount of dividends paid the prior year.

The following graphic is a scanned version of the financial information provided to State Farm policyholders in 1997, shortly before the end of the Class Period (in July 1998):

STATE FARM MUTUAL
AUTOMOBILE INSURANCE COMPANY

Statement of Condition (In Millions of Dollars)

Assets	1997	1996
Cash and Short Term Investments	$ 671	$ 781
Bonds	27,873	26,562
Common & Preferred Stocks	24,347	18,959
Equity in Insurance Subsidiaries	9,523	7,602
Other Assets	7,022	6,988
Total Assets	$69,442	$68,892
Liabilities		
Claims and Claim Expenses	$14,499	$15,625
Unearned Premiums	7,356	7,410
Other Liabilities	9,979	7,804
Policyholder Protection Funds		
Funds for Protection of State Farm Mutual Policyholders	$15,707	$13,479
Investment Fluctuation Reserve	11,736	8,523
Funds Assigned for Protection of Policyholders of Subsidiaries	9,523	7,602
Catastrophe Reserve – Reinsurance	642	449
Total Liabilities and Surplus	$69,442	$68,892

Summary of Operating Data (In Millions of Dollars)

	1997	1996
Premium	$25,277	$24,741
Less: Dollars for Claims	15,618	16,329
Expenses for Paying Claims	3,311	3,326
Service and Administrative Fees	4,990	4,491
Underwriting Gain or (Loss)	1,358	595
Plus: Investment and Other Income	2,726	2,731
Income Before Dividends and Taxes	4,084	3,326
Less: Dividends to Policyholders	651	0
Income Taxes	983	983
Net Income	$ 2,450	$ 2,343

The financial statements of the company are audited by an independent public accounting firm.

Board of Directors

Wendy L. Gramm, Economist and former Chair of the Commodity Futures Trading Commission, Washington, D.C.
Robert K. Jaedicke, Dean Emeritus, Graduate School of Business, Stanford University, Gallatin Gateway, Mont.
Roger Joslin, Senior Vice President and Treasurer, State Farm Mutual; Chairman of the Board, State Farm Fire and Casualty, Bloomington, Ill.
W. H. Knight Jr. Vice Provost, University of Iowa, Iowa City, Iowa
Hanne Merriman, Principal, Hanne Merriman Associates (retail business consultants), Washington, D.C.
John C. Partee, Economist and retired Federal Reserve Board member, Vero Beach, Fla.
George L. Perry, Senior Fellow, The Brookings Institution, Washington, D.C.
Jerry I. Porras, Lane Professor of Organizational Behavior and Change, Stanford University, Stanford, Calif.
Edward B. Rust Jr. Chairman of the Board, State Farm Mutual; President and CEO, State Farm Mutual and its subsidiaries, Bloomington, Ill.
Curtis W. Tarr, Dean Emeritus, Johnson Graduate School of Management, Cornell University, Savannah, Ga.
Vincent J. Trosino, Vice Chairman of the Board; Executive Vice President and Chief Operating Officer, State Farm Mutual, Bloomington, Ill.
James Q. Wilson, Professor of Management and Public Policy, University of California at Los Angeles, Los Angeles, Calif.
Charles R. Wright, Agency Vice President; Senior Agency Officer, State Farm Mutual and its subsidiaries, Lexington, Ill.

SP 00001339

The 1997 Report breaks down the surplus (called "Policyholder Protection Funds") into categories. The Report mischaracterizes the vast majority of State Farm's surplus as "reserves" or otherwise segregated for "special" purposes, while materially understating its assets and income, and overstating its liabilities. In doing so, the Report (like all others during the Class Period) falsely implies that these hidden and segregated amounts are not available for the protection of *mutual*

policyholders or the payment of dividends. The category, "Funds for Protection of State Farm Mutual Policyholders," for example, totals just $15.7 billion. The correct amount should be *$43.9 billion.* AA-9, 02507-02509 & AA-9, 02519; AA-9, 02421 & AA-9, 02424-02425.

Plaintiffs' insurance accounting and financial reporting expert, Loren Kramer, CPA, their actuarial expert, Mr. Toothman, and their corporate governance expert, Prof. Bebchuk, testified that this presentation was materially misleading (AA-8, 02170-02171; AA-9, 02421 & AA-9, 02424-02425; AA-9, 02507-02509 & AA-9, 02519), and Mr. Kramer inferred it was deliberately so: it was "designed to conceal the true amount of surplus from which dividends to policyholders can be paid." AA-8, 02170–02171.[12] *See also Feit v Leasco, supra,* 332 F. Supp. at 572 (failure by directors of insurance company to investigate and disclose reasonably estimated amount of "surplus surplus is so significant that under any test proposed it is material.").

The 1997 Report categorized $11.7 billion of State Farm's surplus under the mysterious title of "Investment Fluctuation Reserve" ("IFR"). This is not really a reserve at all, but an aggregate of the market value appreciation in the equity component of State Farm's investment portfolio. Calling it a reserve gave policyholders the false impression that it was unavailable for the payment of dividends. *See* AA-8, 02170-02173; AA-9, 02421 & AA-9, 02424-02424; AA-9, 02507-02508; AA-8, 02061-02062.

Beginning in 1991, without notifying policyholders State Farm took 35% of the equity portfolio appreciation out of IFR and sequestered it among "Other Liabilities," purportedly to cover capital gains tax liability on unrealized equity gains. State Farm admitted that no other insurance companies followed that

---

12 Mr. Kramer reached the same conclusion and expressed the same opinion with respect to State Farm's 1997 Annual Report to Policyholders. AA-9, 02421.

practice during the Class Period. AA-8, 02173–02174; AA-8, 02291. Plaintiffs presented expert testimony, however, indicating that no such liability would ever materialize. AA-8, 02296. By 1998, this undisclosed exclusion from surplus exceeded $7 billion (more than 2 ½ times the amount of dividends paid during the 15-year Class Period).[13] AA-8, 02173–02174; AA-8, 02298-02299. From 1990 on, the Annual Reports also understated surplus by reporting the value of bonds at cost rather than market value without notifying policyholders of that accounting treatment. *E.g.*, AA-13, 03509, 03521. By the end of 1998, this accounting treatment underreported surplus by over $2.4 billion (in contrast to the Board's undisclosed internal "net worth" valuations). AA-13, 03638; AA-8, 02175– 2176; AA-8, 02061–02062; AA-9, 02421 & AA-9, 02424-02425.

Management also failed to recognize anticipated salvage and subrogation recoveries as a reduction to the liabilities it reported to policyholders. An internal memorandum noted that failure to recognize salvage and subrogation recoveries "impacts . . . operating results via incurred losses, as well as the balance sheet liabilities and surplus." AA-13, 03736. In 1996, for example, this amount embedded in State Farm's "loss reserves" totaled approximately $1.2 billion, which the Board's undisclosed, internal "net worth" analysis included as an *asset* in "unassigned surplus." AA-12, 03436. Mr. Kramer concluded that this undisclosed accounting treatment misled policyholders regarding the true amount of State Farm's surplus. AA-8, 02174.

Also without notifying policyholders, State Farm took an additional $3.6 billion in net worth "off books" by over-funding management's pension plans. AA-9, 02509; AA-8, 02175-02176.

---

[13] Contrary to what the Annual Reports told policyholders, the Board's undisclosed, internal financial reports *included* the purported tax "liability" as part of the "policyholder protection fund." AA-5, 01408.

Taken together, these examples of misreported and undisclosed assets and inflated liabilities evidence bad faith by which the directors of a mutual company may forfeit the protection of the business judgment rule. *Parish v. Maryland & Virginia Milk Producers Ass'n,* (1968) 250 Md. 24, 242 A.2d 512 (dishonest Annual Reports to Members, among other misconduct, forfeited business judgment rule protection), *superseded by statute in part on other grounds, Flaherty v. Weinberg* (1985) 303 Md. 116.

Rather than directly confronting Plaintiffs' evidence that State Farm's Annual Reports were misleading, the trial court concluded that this evidence was beside the point, as it did not "link" the deceptive Annual Reports "to the Board's decisions concerning dividends and surplus in a way that would cast doubt on the good faith of the Directors in making those decisions," because "Plaintiffs do not offer evidence that this communication was from the Board of Directors or was approved by the Board." SJO at 24 (AA-23, 06476)

But there was evidence sufficient to create a triable issue of fact on that point. Annual Reports were issued over the signature of the company's Board Chairman and specifically list each Board members by name and title. [*See* AA-13, 03503 - 03534.[14] Further, directors of Illinois corporations are presumed to be aware of basic corporate financial documents, such as Annual Reports to the corporation's owners. *See F. H. Hill Co. v. Barmore* (1920) 220 Ill. App. 222, 230 (directors of an Illinois corporation, "as trustees of the corporation and responsible for its conduct, must be charged with a reasonable knowledge of its accounts"); *In*

---

14 *Cf. Graham v. Taylor Capital Group* (D. Del. 2001) 135 F. Supp. 2d 480, 503 ("key corporate officers should not be allowed to make important false financial statements knowingly or recklessly, yet still shield themselves from liability to investors simply by failing to be involved in the preparation of those statements. [Citation omitted.] This court finds that this rationale applies equally to the director defendants here.") (internal quotation marks omitted).

re Illinois Valley Acceptance Corp. (S.D. Ill. 1982) 531 F. Supp. 737, 740 ("Generally, knowledge of corporate records and documents is imputed to all directors").[15]

Even when the law "imposes no duty upon directors to furnish annual reports to shareholders (citation omitted), corporate directors must honestly disclose all material facts when they undertake to give out written statements concerning the condition or business of their corporation[.]" *Hall v. John S. Isaacs & Sons Farms, Inc.* (Del. Ch. 1958) 146 A.2d 602, 610 (*rev'd in part on other grounds*, 163 A.2d 288 (1960). *Accord Kelly v. Bell* (Del. Ch. 1969), 254 A.2d 62, 71 (*aff'd* 266 A.2d 878 (Del. Supr.1970) ("[o]f course directors owe a duty to honestly disclose all material facts when they undertake to give out statements about the business to stockholders."); *Marhart, Inc. v. CalMat Co.* (Del. Ch. Apr. 22, 1992, C.A. No. 11,820) 1992 Del. Ch. LEXIS 85 (same); *Malone v. Brincat* (Del. 1998) 722 A.2d 10, 14 (same). Illinois law concurs. *Johnson v. Central Standard Life Ins. Co., supra*, 102 Ill.App.2d at 31-32.

Plaintiffs' evidence, along with reasonable inferences from that evidence, create a triable issue as to whether the Board forfeited business judgment rule protection for its dividend decisions by issuing reports to policyholders which falsified the basis for those decisions.

---

[15] *See also, F.D.I.C. v. Lauterbach* (7th Cir. 1980) 626 F.2d 1327, 1334 ("A corporate director may not claim total ignorance of the corporation's affairs, particularly those matters fairly disclosed by the directors' meetings and those corporate records to which directors had access."); *Hoye v. Meek* (10th Cir. 1986) 795 F.2d 893, 896 ("directors and officers are charged with knowledge of those things which it is their duty to know and ignorance is not a basis for escaping liability").

VII. CONCLUSION

For the reasons stated above, the trial court's summary judgment should be reversed.

Dated: April 26, 2007

Respectfully submitted,

HENNIGAN, BENNETT & DORMAN LLP
GIANELLI & MORRIS
ROBERT S. GERSTEIN
ERNST & MATTISON

By: J. Michael Hennigan (MAA)
J. Michael Hennigan

Attorneys for Plaintiffs and Appellants
Jerry Hill, Josephine Hill, Wilson Mallory and Norene Mallory, Individually and on Behalf of the Plaintiff Class

* * *

CERTIFICATE OF WORD COUNT

(Cal. Rules of Court, Rule 8.204(c)(1))

The body of the text of Appellants' Opening Brief consists of 13,915 words, including footnotes, as counted by the Microsoft Word 2000 word processing program used to generate this Brief.

DATED: April 25, 2007

By:
Mark Anchor Albert