Putting An End to the Game of Chance in Insurance Rate Making

By Sam Sorich and Kimberly Dellinger Dunn

Recently, one of our most respected jurists, Justice Walter Croskey of the California Court of Appeal, issued a landmark ruling in *MacKay v. Superior Court* (188 Cal. App. 4th 1427 *Oct. 6, 2010*). The actual opinion follows the formula familiar to legal scholars for a Croskey opinion. It is thoughtful, balanced, firmly grounded in California law, and ultimately consistent with the result reached by virtually all courts across the nation, state and federal, to have considered the issue. Still, some have attacked Justice Croskey's opinion for putting an end to a lucrative cottage industry built up upon Proposition 103 and dreamt up by class action lawyers 10 years after that proposition passed.

FIRST IN A TWO PART SERIES

The reality is that Proposition 103 is untouched by the Croskey opinion, but the attorney fees spigot is shut off. Justice Croskey carefully underscored that the opinion does not confer "immunity," it simply limits consumers to the specific remedies described in the rate statutes:

"Plaintiffs repeatedly argue that our conclusion grants insurers 'immunity' for their illegal practices. Insurance Code [S]ection 1860.1 does not grant immunity; it simply limits plaintiffs to an administrative remedy (with judicial review). Plaintiffs' concern is not that insurers will be left free to charge illegal rates, but, rather, that they will be unable to collect damages or obtain disgorgement of any illegal premiums collected. There is no injustice in exempting an insurance company from disgorging premiums collected pursuant to a rate which has been approved in advance by the commissioner. (Cf. Ins. Code, [Section] 1858.07 [providing no civil penalties may be imposed for the use of an approved rate].) (p.1449, note 19)"

As Justice Croskey affirms, insurers should be allowed to rely upon an official rate approval issued by the Insurance Commissioner. Once an insurer negotiates the onerous California rate approval process, it should not then be subjected to a game of chance, where it may be held liable for charging rates approved by the Commissioner, which are, by statute, the only rates the insurer is permitted to charge.

Proposition 103 introduced to California what is possibly the most rigorous, active, intrusive and confining system of insurance rate regulation in the country. The price for most products we buy, from coffee to cars, is set by the seller's choice based on what the market will bear. Not so the insurance that covers the lawsuit over the hot coffee spill, or the insurance that covers the car. For most insurance, the insurance company can only charge the price that has been pre-approved by the Insurance Commissioner. The process for obtaining that approval is intense. The insurer must submit specified data and justifications for its proposed rates. It must follow a prescribed "template," and is limited to an expense level deemed "efficient," and to a modest profit. Insurance Department analysts and actuaries scrutinize each filing, and the Commissioner cannot approve any proposed rate that is "excessive, inadequate, unfairly discriminatory, or otherwise in violation of" the rating laws.

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Not only are rate filings subjected to scrutiny by experts within the Insurance Department, "any person" can ask the Department to hold a rate hearing, and can intervene in the review process. All rate filings are public. They are available physically at Department viewing rooms in Los Angeles and San Francisco, and available on the Department's Web site. If a consumer does elect to intervene, he or she can choose any advocate or represent him or herself — the consumer does not need a lawyer. Further, the consumer can obtain compensation for the advocacy covering any amounts spent to intervene, including submissions and discussions made in the review process even without a hearing. If at the end of the process the consumer disagrees with the Commissioner's decision, the consumer is guaranteed the right to a court review of that decision.

The system also includes ample provision for enforcement and penalties. In addition to the exacting review process an insurer must undergo before obtaining approval in the first place, the Commissioner performs regular and targeted field rating and underwriting exams which, among other things, allow the Commissioner to continue to ensure that the rates in effect continue to meet the standard. Again, consumers have their own rights to participate in the process. Consumers can also initiate actions by bringing complaints concerning rates in effect, and have the same rights to compensation and to guaranteed judicial review of any decision by the Commissioner.

Insurance companies face harsh financial sanctions for any violation of the rating laws. Insurers can be fined $5,000 for each act in violation of the rating laws, or $10,000 for each act if "willful," with additional penalties of $100,000 and $250,000 for non-compliance with orders. The Commissioner can even suspend or revoke the insurer's right to do business in California.

Under this system, the Commissioner reviews and must approve all proposed rates before they can be charged. The courts review the Commissioner's decisions. Consumers have the right to participate at all stages, and have a guaranteed right to court review of the Commissioner's decisions. But at the end of it, the insurance company must charge the approved rates, and cannot be sued for so doing.

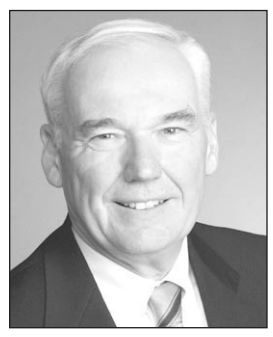
Ten years after Proposition 103's passage, a group of individuals fronted an attempt to create a new civil action, seeking monetary relief and attorney fees, based on the Proposition 103 rating laws. The lawsuit alleged that the approved rates charged by 70 auto insurers violated the Proposition 103 rate laws. This case ultimately resulted in Justice J. Anthony Kline's landmark opinion in Walker v. Allstate Indemnity Co., 77 Cal. App. 4th 750 (2000). The plaintiffs' lawyers' theory was creative. Proposition 103 contains a statute (Insurance Code Section 1861.03(a)) making the business of insurance subject to the same California business laws applicable to all other businesses operating in the state, a list encompassing over 1000 laws.

Indisputably, Proposition 103 provides that "the business of insurance shall be subject to the laws of California applicable to any other business...." (Insurance Code Section 1861.03(a)). But other businesses are not subject to price regulation, and the general business laws certainly don't make businesses subject to civil liability for charging an approved price in accordance with a statutory mandate.

In *Walker*, plaintiffs' lawyers gave Section 1861.03(a) a novel twist. They argued that this statute should be read as incorporating California's 1000 plus business laws into the Insurance Code as additional remedies for violation of the rating statutes, such that any general business law could be used to challenge approved rates as violating some part of the rating statutes. The attorney general filed a brief explaining: "The administrative regulatory scheme of the McBride Act provides that the Commissioner is the exclusive original forum for ratemaking, complaints and related issues."

Justice Kline, writing for the California 1st District Court of Appeal, rejected plaintiffs' creative argument: "If [Insurance Code Section] 1860.1 has any meaning whatsoever (which under the rules of statutory construction it must), the section must bar claims based on an insurer's charging a rate that has been approved by the commissioner under the McBride Act. The statutory scheme enacted by the voters in Proposition 103 compels this result. Under this scheme, the *commissioner* is charged with setting rates after an extensive hearing process in which consumers and interested parties are encouraged to participate. [The Court then describes the process, see above.] When this process has run its course, the insurers must charge the approved rate and cannot be held civilly liable for so doing. ([Insurance Code Sections] 1861.01, subd. (c), 1858.07, 1859.1, 1861.05, 1861.09). (p. 756)"

The rule precluding civil actions challenging approved rates has been dubbed the "*Walker* doctrine," after Justice Kline's well-reasoned opinion — a doctrine that is often conveniently overlooked by plaintiff's attorneys and others engaged in ratemaking hearings.



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Never Pay Income Tax on Your Retirement Plan

By Bruce Givner and Owen Kaye

Late in the year, professionals and other taxpayers examine ways to intelligently lower the income tax due on their April 15, 2011 personal returns. There are only a few safe, reliable income tax deductions: interest on the first $1.1 million on the mortgage on a principal residence; charitable deductions; and oil and gas. The list rapidly falls off after that.

Perhaps the largest, and yet one of the safest, deductions in the Internal Revenue Code is a contribution to a tax qualified employee retirement plan. This might be a profit sharing plan, a money purchase pension plan, a Section 401(k) plan, a cash balance plan, a target benefit plan or a defined benefit pension plan. A corporation, a partnership, an LLC or even a sole proprietorship might sponsor the plan. (The latter is especially important since so many lawyers practice as sole proprietors.) The National Office of the Internal Revenue Service does not opine on the amount of the deductible contribution to a tax qualified employee retirement plan. However, it will issue a *favorable determination letter* on the form of the retirement plan, which is a source of a great deal of comfort to the taxpayer taking the deduction.

As we know from the O.J. Simpson saga, retirement plans have another benefit: an extraordinary degree of creditor protection. Whether you kill someone, steal, or commit massive malpractice, your retirement assets are exempt from all creditors, with three exceptions: the U.S. government (The California Franchise Tax Board is not similarly privileged, which means that your retirement plan assets are protected against a lien for unpaid state income taxes); an order for child support; and an order for spousal support. And California's laws protecting retirement plans — Code of Civil Procedure Section 704.115 — is broader and more protective than federal law.

Some tax advisors counsel that taxpayers should not contribute to a retirement plan but, instead, "pay the tax and pocket the difference." Why? In some situations the cost of covering the rank and file employees is viewed as too expensive. In other situations, the cost of maintaining the plan, e.g., filing the annual reports, is viewed as too expensive and complicated. In still other situations, advisors believe that tax rates will surely increase in the future, e.g., to retire the exploding national debt. Therefore, taxpayers are better off investing the after tax proceeds today in muni bonds, rather than deferring the tax to some future day when the rates will be significantly higher.

The purpose of this article is not to prove the first two points (the costs of covering the rank and file and paying for administration) false, though they almost invariably are. Instead, the purpose of this article is to point out that many taxpayers who contribute to a retirement plan today will *never pay the income tax*. That is, and should be, an astonishing statement. Most tax advisors view a retirement plan as a tax deferral vehicle: you get a deduction today, the money accumulates in the plan on a tax *deferred* basis, and you pay the income tax when you receive a distribution. However, the little known fact is that — at least for our clients — they never pay the income tax because they do not need the money at retirement. All they take from the retirement plan are the "required minimum distributions."

Congress added the requirement for minimum distributions to the Internal Revenue Code in an attempt to restrict retirement plans to providing for the retirement of the participants. At that time, retirement plans had become a way to pass on wealth to the next generation. However, the manner in which the IRS has promulgated the rules regarding required minimum distributions does not necessarily accomplish their intended purpose. As a result, taxpayers who do not need the money from their retirement plans are able to pass the wealth on to their heirs.

Required minimum distributions must begin no later than April 1 of the year after the year in which you reach 70 and a half years old — after which a percentage of trust assets must be distributed every year. Note: although the thrust of this article has been about employee retirement plans, the rest of this discussion applies equally to non-Roth IRA's.

Imagine that our retiree starts with $1 million at age 70, takes the required minimum distributions each year and manages to earn 6.5 percent on his retirement trust investments. How much is left at his death at age 87? $1,050,000. In other words, our retiree paid tax on the earnings, but never on the principal of his retirement trust. The principal passes to his heirs. Of course if the heir is the retiree's spouse, the principal passes free of estate tax. If the heirs are the retiree's children, that may be free of estate tax depending upon the nature of our estate tax laws at the time and the size of the retiree's estate.

What if our retiree *only* manages to earn 5 percent on the investments in his retirement trust? Then only $943,000 is left in his retirement trust. So, unfortunately, he has to pay income tax on $57,000 of the principal. This is hardly a reason to hesitate from establishing the plan in the first place.

While there are ways to directly and indirectly eliminate the estate tax from retirement plan benefits — when it comes to tax qualified employee retirement plans, an income tax deferred may be a tax never paid.

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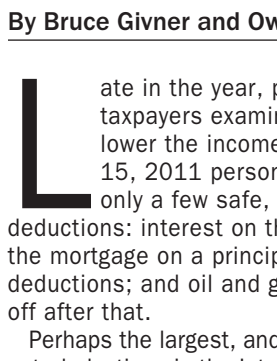

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