Hogan Lovells

Hogan Lovells US LLP
525 University Avenue
4th Floor
Palo Alto, CA 94301
T +1 650 463 4000
F +1 650 463 4199
www.hoganlovells.com

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Bryant Henley
Assistant Chief Counsel
California Department of Insurance
300 Capitol Mall, 17th Floor
Sacramento, CA 95814

Re: State Farm Companies' Comments On Workshop OV-2011-00076

Dear Bryant:

This letter sets forth the comments of State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company, and State Farm General Insurance Company (hereinafter collectively "State Farm") following the above-captioned workshop.

State Farm is supportive of many of the Department's goals underlying the proposals. Nonetheless, State Farm continues to believe that it is at best premature to conclude that regulations are necessary, or to generate text that will accomplish the Department's purpose without creating greater problems than the proposed regulations solve. With respect to what is described as "the *MacKay* issue", State Farm notes that there have been perhaps a handful of rate applications since the *MacKay* group of cases were filed in 2001 presenting the issues addressed in *MacKay*, out of the 7000 rate applications the Department estimates are filed every year. State Farm suggests that Department resources could be more productively channeled to a rulemaking addressed to revising the rate regulations to allow more accurate rate projections and more efficient processes.

Without intending any waiver or discount of its serious misgivings regarding the wisdom of proceeding with a rulemaking, State Farm offers the following specific comments.

Concept 1: Discussion

The Department is considering this concept in order to make clear exactly what is encompassed in the approval of a class plan application or rate application. There appear to be two concerns: (1) an insurer/applicant will "bury" inappropriate material somewhere in the application and then later assert that it was approved; and (2) an insurer/applicant will assert that information necessary to consider whether a proposed rate is inadequate, excessive or unfairly discriminatory – but not itself constituting part of the rate – is approved. An example of (2) would be policy forms. A policy form change may have rate impact, and the form itself would be necessary to assess the question. While the insurer/applicant's estimate of the rate impact of the form change and the ultimate rate resulting therefrom are approved, the form itself is not approved.

Again, State Farm respectfully suggests that problems of this nature arise too infrequently to warrant the inevitable mischief that will result from the contemplated regulations.

A fundamental concern with the proposal as drafted is a too narrow description of what is approved. Viewed from one perspective, all that is "approved" is what the insurer will charge. The insurer charges a rate, not a filing memorandum or a template. Nor does an insurer charge a component of a rate, or a calculation necessary to support a proposed rate or a proposed class plan.

For example, CDI Senior Actuary Sharon Li raised the questions of whether, technically, one would appropriately identify the base rate as what is approved, since the base rate is not what is actually charged. The base rate is applied to the classification relativities to determine the rate actually charged to the insured, depending on the risk/rate characteristics of that particular risk.

While State Farm understands the point, it is vital that the base rate be approved, and is understood to be approved. The base rate is the measure by which the Department determines that the insurer's rates overall for the state are not excessive or inadequate. The Department does approve the base rate for this purpose. It is also vital that the rating factors, classifications, relativities and criteria for placement within a classification be approved, and are understood to be approved, for all lines. These elements are the bases examined by the Department to determine whether the proposed rates are not unfairly discriminatory. The Department does approve these elements of the rating plan in determining that the rates produced by the plan are not unfairly discriminatory.

Further, from a different, practical perspective, every component and every articulation by the insurer of its rating plan must be considered approved. The filing memorandum itself might not be "approved", but the rating plan described therein is at the center of what the insurer is asking the Department to approve, and must be considered approved. The template itself may not be approved, but it is the basis for the Department's approval of the rate. The Department and the insurer might not have reached agreement on each component of the rate, but the Department did conclude that the proposed rate (perhaps as modified) met the standard for approval as developed by the regulations.

That is to say, none of the things described in the preceding paragraph can form the basis for a valid challenge in the form of a civil action, either because the component or calculation formed the basis for the approval, or because it is not relevant. For example, a plaintiff's lawyer might file a civil action asserting that the insurer violated Insurance Code § 1861.02(a) because its "weighting" failed to meet the requirements of 10 C.C.R. § 2632.8. Currently, the "weighting" calculation is listed as part of the Part II "not approved" section of the class plan application. A court might understand from this that the Department does not base approval of the class plan on the insurer's demonstration of compliance with § 2632.8, and might allow such an action to proceed. Of course, the classification relativities are approved ***based on*** the insurer's compliance with § 2632.8 (and § 2632.7) in proposing them. The class plan is approved ***as compliant with*** the weighting and sequential analysis requirements, even if an actuary would say that it is the relativities – not the calculations – that are approved.

As another example, the Department may not agree with a specific selection made by the insurer, but the proposed rate (perhaps as modified) falls within the acceptable range projected by the regulations, and is approved. A disagreement as to the component is irrelevant, because it does not render the rate "excessive". But if the components are listed as unapproved, an alleged failure to comply with the regulations might become a subject for a civil action, due to a misunderstanding of what it means to include the components in the "unapproved" list.

Concept 1: Suggestions

First, State Farm suggests that the base rate and the rating factors, classifications, relativities and criteria for inclusion within a particular classification are necessary to approval under the statutory standard and must be approved. As noted in the Discussion Section, the rating factors, classifications, relativities and criteria for inclusion within a particular classification are and must be reviewed by the Department to approve the proposed rates as not unfairly discriminatory (i.e., as substantially related to risk of loss). But, it is a rate approval. Other than with respect to Private Passenger Auto (which has additional statutory mandates set forth in Insurance Code § 1861.02), the Department's mandate extends to rates, and the approval is a rate approval.

State Farm further suggests that the methodology by which the base rate and rating factors are applied to calculate the rate must be approved. The approved methodology is necessary to proper application of the base rate and rating factors to generate the approved rate. If a different methodology were used the resulting rate would not be the approved rate.

Secondly, State Farm suggests decoupling the categorization of what is not approved from identification of compulsory submissions for a rate application. There is no necessity for the connection, and connecting the two distinct concepts requires categorization of material that is really neutral, i.e., does not have to be considered approved or not approved. Based on the Workshop comments, this change – which would drop things like "template", "trend", filing memorandum", "excluded expenses" etc from the "unapproved" list – would address the bulk of the industry objections, and not affect the Department's purpose.

This change would leave the Department free to specify by category the material that it affirmatively does not approve, such as policy forms and underwriting guidelines (except to the extent this term includes criteria that are part of the rating plan). State Farm believes that it would avoid confusion for the Department to specify that it approves the estimate of the rate impact of a policy form change or rule change, rather than the form or rule change itself.

State Farm underscores that these are conceptual suggestions, which would require actual drafting efforts in order to explore whether they effectively address the valid objections raised by stakeholders.

Concept 1: Objections

Should the Department proceed with Concept 1. State Farm has some specific objections.

Under Insurance Code § 1861.05, the commissioner has authority to approve a rate application or to notice a hearing. This is likewise the authority for requiring approval of a class plan application – there is no other basis within Article 10 for that authority. The Commissioner does not have the authority to reject a rate application or class plan application without a hearing. Certain proposed amendments within § 2632.11(a) and § 2648.4(a) are inconsistent with statute and purport to expand the commissioner's authority beyond its statutory scope, in stating that the commissioner may "reject" the rate application or class plan if he concludes that the submission does not meet the requirements of Division 1, Part 2, Chapter 9 of the Insurance Code.

Certain language in proposed amendments to § 2648.4(a) appears to appoint the prior approval instructions as "regulations", on a revolving basis as the instructions may be amended, without any rulemaking process meeting due process requirements. This may well have been an unintended by-product of combining the "approved/unapproved" concept with the "complete rate application"

concept. State Farm objects to the wholesale appointment of the prior approval instructions as regulations, without due process. State Farm suggests that the language could be amended to state: "In order to be complete, a rate application must be submitted on the forms developed by the Department and comply with the then-current rate application instructions, available on the Department of Insurance website." State Farm suggests that the "approved/unapproved" concept be place in a separate regulation.

Concept 2: Discussion

At the Workshop, State Farm underscored the tension between Insurance Code § 1861.07, and the status of trade secrets as constitutionally protected property. As State Farm also explained, in the *State Farm Mutual Automobile Ins. Co. v. Garamendi* case, State Farm chose to address only the question of the correct statutory construction of Insurance Code § 1861.07, and expressly reserved the constitutional question. Trade secrets are by definition destroyed by public disclosure. Government cannot take trade secrets by compelling that they be submitted and subjected to public disclosure. *See Phillip Morris, Inc. v. Reilly*, 312 F.3d 24 (1st Cir, 2002).

State Farm appreciates the Department's effort to balance competing interests. State Farm agrees with the concern that the proposed regulation is likely to add complexity and burden to an already complex and burdensome process.

Concept 3: Discussion

At the Workshop, the Department explained this concept as intended to state in a regulation the current requirement that form and rule changes be filed for approval of the estimated rate impact of the form or rule change. This explanation appears substantially different from the explanation stated in the Workshop Notice. The Workshop Notice quotes the portion of the standard approval letter stating that the rate approval does not constitute approval of underwriting guidelines or policy forms, and in that context suggests that the regulation would require that an insurer obtain prior approval of underwriting guidelines and policy forms.

It is not clear from the text of the regulation what is intended.

As discussed at the Workshop, it is currently the case that form and rule changes with rate impact (such as broadening or restricting coverage or heightening qualification criteria for a rate discount) must be submitted for approval of the insurer's estimate of the rate impact of the change, not for approval of the form or rule itself. Rule and form filings make up the bulk of the estimated 7000 filings the Department receives annually. It does not appear that the Department experiences a compliance problem, suggesting that there is no necessity for a regulation.

State Farm notes that the term "rating method" is defined so broadly as to be incomprehensible, and appears to be much broader than the customary understanding of forms and rules with rate impact. State Farm believes that the broad and vague definition will defeat reasonable attempts at compliance and permit arbitrary prosecutorial discrimination. As the California Supreme Court explained (by quoting a U.S. Supreme Court opinion):

> "Vague laws offend several important values. First, because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly. Vague laws may trap the innocent by not providing fair warning. Second, if arbitrary and discriminatory enforcement is to be prevented,

> laws must provide explicit standards for those who apply them. A vague law impermissibly delegates basic policy matters to [agencies], judges and juries for resolution on an *ad hoc* and subjective basis, with the attendant dangers of arbitrary and discriminatory application."

Cranston v. City of Richmond, 40 Cal. 3d 755, 763 (1985) *quoting Grayned v. City of Rockford*, 408 U.S. 104, 108-109 (1972) (footnotes omitted by court) ("agencies" substituted for "policemen" to account for context).

Concept 4: Discussion

At the Workshop, there appeared to be confusion regarding the meaning and purpose of the proposed changes to 10 C.C.R. § 2632.2. On the one hand, this proposed amendment was described as making it clear that an insurer is only permitted to use rating factors identified in Insurance Code § 1861.02(a) and 10 C.C.R. § 2632.5 in private passenger auto rating plans. State Farm submits that existing statutory and regulatory law is abundantly clear on that point.

On the other hand, this proposal was characterized as an attempt to undermine and reverse by regulatory fiat the Court's opinion in *MacKay v. Superior Court*, 188 Cal. App. 4th 1427 (2010) by amending a regulation the Department believes is necessary to that holding. While the industry does not agree that the regulation has that force, and Consumer Watchdog has not agreed with the Department's analysis, the industry and Consumer Watchdog read this proposal as inconsistent with the opinion in *MacKay*.

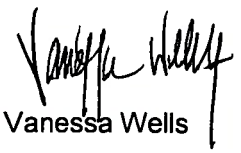
Under Proposition 103 as construed in *MacKay* and the earlier case *Walker v. Allstate Indem. Co.*, 77 Cal. App. 4th 750 (2000), once an insurer has endured the elaborate process required for approval of a rate, and obtained that approval, the insurer must charge the approved rate. The law compels it. A later change in law or change in philosophy at the Department cannot retroactively change what rate the insurer was compelled to charge during the period of the rate – the insurer was required to charge the approved rate, and that approved rate cannot retroactively be labeled "illegal" based on subsequent events. The insurer can be made to change the rate on a prospective basis and is subject to penalty if it refuses. But the insurer cannot be penalized for charging the approved rate. It is not correct to say that charging a rate subsequently dubbed "illegal" violates Insurance Code § 1861.02(c). That section requires an insurer to charge the approved rate.

This correct analysis of the Article 10 statutes – set forth in *MacKay* – does not depend on the language of 10 C.C.R. § 2632.2. It is an analysis of the statutes adopted by Proposition 103, and is by definition part of that law. The commissioner lacks authority to adopt a regulation inconsistent with Proposition 103 as construed by the appellate courts of this state.

An insurer cannot be compelled to operate in an uncertain environment, unable to predict when it may suddenly be accused of illegality for charging a rate for which it duly obtained prior approval.

This proposal creates an untenable operating environment to address a non-existent problem. It should not be adopted.

Respectfully submitted,



Vanessa Wells

Partner
vanessa.wells@hoganlovells.com
D 650 463 4022