CALIFORNIA COURT OF APPEAL
SECOND APPELLATE DISTRICT
DIVISION ONE

No. B194463

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

Plaintiffs and Appellants,

vs.

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY, STATE FARM LIFE INSURANCE COMPANY, and DOES 1 through 100, Inclusive,

Defendants and Respondents.

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

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CERTIFICATE OF INTERESTED ENTITIES OR PERSONS

Court of Appeal Case Number: B194463

Case Name: Hill v. State Farm Mutual Automobile Insurance Company

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Name of Interested Entity or Person	Nature of Interest
1. State Farm Mutual Automobile Insurance Company	No companies or individuals have an ownership interest of more than ten percent in State Farm Mutual Automobile Insurance Company.
2.	
3.	
4.	

Please attach additional sheets with Entity or Person Information if necessary.

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I. INTRODUCTION

Appellants complain that between 1983 and 1998 State Farm Mutual Automobile Insurance Company ("State Farm") "amass[ed] surpluses far in excess of what State Farm reasonably needed to meet its present and future insurance obligations . . . ." *State Farm Mut. Auto. Ins. Co. v. Superior Court* (2003) 114 Cal.App.4th 434, 439 ("*Hill II*"). They claim that the "excess" surplus should have been sold and the proceeds distributed as dividends to the policyholders. *Id.*

The trial court correctly found that the amount of State Farm's surplus reflected the business judgment of its Board of Directors. Under the business judgment rule, the Directors' decisions are presumed to be correct. Appellants failed to satisfy the heavy burden of presenting evidence that would overcome the rule's presumption of correctness.

II. SUMMARY OF ARGUMENT

"An insurer's 'surplus' is the excess of assets over liabilities." *Id.* at 441. Surplus can serve a number of different purposes, including providing "a safety cushion" to help maintain "solvency during periods of unfavorable operating results" and "to support growth." *Id.* at 440-41 (citations omitted). Consequently, "'[i]t is impossible to specify the "right" amount of [surplus] for most insurers through a formula.'" *Id.* (citations omitted). In fact, "decisions as to strategies for managing the surplus funds of an insurer are

quintessential exercises of business judgment." *Lee v. Interinsurance Exch.* (1996) 50 Cal.App.4th 694, 710.

Under the Illinois business judgment rule (which this Court has held governs), "'a court will not disturb the judgments of a board of directors if they can be attributed to any rational business purpose . . . .'" *Hill II*, 114 Cal.App.4th at 445 (citation omitted). To overcome the business judgment rule, Appellants must present evidence that the Board acted "'fraudulently, illegally, or without becoming sufficiently informed to make an independent business decision.'" *Id.* at 450 (citation omitted). As this Court recognized, under Illinois law, Appellants' burden is "'particularly stringent.'" *Id.* at 451 (citation omitted).

The trial court correctly determined that Appellants failed to meet that burden. State Farm's officers and directors studied the Company's surplus in great detail and affirmatively decided that State Farm should continue to retain surplus at the levels it held. The Board's decision to retain surplus resulted from its judgment that "it was more appropriate and in the best interests of our policyholders to retain our investment earnings, including the unrealized gains on Surplus to allow for greater security and financial strength for our policyholders and to enhance our ability to provide stable and low rates and premiums to our policyholders." (AA5-001382:16-22 (Trosino Decl. ¶ 19).) Appellants may disagree with State

Farm's strategy, but under the business judgment rule, their preference for a different approach does not give rise to a claim.

A. State Farm's Motion For Summary Judgment

State Farm moved for summary judgment on the grounds that its Board made rational and informed decisions regarding levels and uses of surplus, and those decisions were protected by the business judgment rule. (AA2-00315-362.)[1] In support of that motion, State Farm presented unrebutted evidence that:

(a) The Board has continuously been comprised of individuals of unquestioned ability and integrity, including a retired Federal Reserve Board Governor, the former Chief of the Commodity Futures Trading Commission, as well as other business leaders, and deans and professors from leading business and law schools (AA19-05199:14-26);

(b) The Board members were regularly provided with massive amounts of data concerning all aspects of State Farm's financial condition, including surplus, and they discussed the data in detail during quarterly board meetings (AA2-00368-376 [UF:21-68], 00378-379 [UF:80, 85]);

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[1] Matters of form: Appellants' Appendix will be referred to as "AA" followed by the volume number, followed by the page number or, where available, the page and line number. Appellants' Opening Brief will be referred to as "AOB" followed by page numbers. The trial court's August 2, 2006 Opinion and Order granting State Farm's motion for summary judgment will be referred to as "MSJ Op." followed by page number.

(c) State Farm used surplus not only to (1) provide a cushion of solvency and (2) fund growth, but also (3) to reduce its policyholder premiums. All of State Farm's surplus is invested and the income and gains from this invested surplus help offset costs and add to State Farm's strength, which in turn allows State Farm "to charge lower and more stable insurance rates than would otherwise be possible." (AA5-01164:10-11.) Specifically, during the class period, State Farm's invested surplus, including the unrealized capital gain, permitted State Farm to move its underwriting target to 0 and then to -5%. (AA2-00367-368 [UF:13, 15-16], 00377 [UF:76], 00379-382 [UF:88-89, 91-92, 94, 101, 104-09]);

(d) The Board, having reviewed multiple reports on surplus and State Farm's financial condition, concluded that State Farm never had more surplus than it needed to accomplish these three goals (AA2-376-377 [UF:72, 74-75]);

(e) State Farm priced its insurance policies to break even, or even produce an underwriting loss, with no provision for a dividend. Accordingly, the Board generally declared dividends only when results from insurance operations in the previous year were better than projected and had produced an underwriting profit (AA2-00383-384 [UF:111, 113]); and

(f) Over the 15-year class period in issue, 1983-1998, the Board declared ten dividends totaling more than $1.8 billion for mutual company

policyholders. (AA2-00383 [UF:110].) In 2000, the Board declared a $1 billion dollar dividend, bringing the total since 1983 up to $2.8 billion. (*Id.*)

B. The Trial Court's Opinion

The trial court granted State Farm's motion for summary judgment, finding: "the Board did deliberate about the uses and adequacy of the Company's surplus." (MSJ Op. 19.) From those deliberations, the Board found that State Farm did not have more surplus than it needed to meet its three goals of protecting its solvency, funding growth and using income to continue to charge low premiums. (*Id.*) Accordingly, the trial court found in language that warrants direct quotation:

> The predicate for reducing surplus by paying dividends is a determination that the operational needs of the company are adequately met by the amount of surplus it has. Members of the State Farm Board never concluded that those predicate conditions existed, and therefore they did not breach a duty by failing to deliberate about payment of dividends from surplus.

(*Id.*)

This finding captures, in a nutshell, what this case is all about. The Board's strategy was to use surplus for the three-fold purpose of (1) providing a solvency cushion, (2) funding growth, and (3) reducing premiums. (AA5-01164:10.) Unless and until the Board determined that the Company had more surplus than it needed to accomplish all three of those purposes, there was no occasion to discuss using "excess" surplus for

some fourth purpose. The "predicate" for discussing other uses of surplus – such as paying dividends – never occurred. (MSJ Op. 19.)

The "undisputed evidence establishes that the Board of Directors of State Farm monitored the company's surplus and made informed judgment about the appropriate level of surplus for the benefit of the Company." (*Id.* at 22.) Appellants simply disagree with the Board's decisions: "At root, Plaintiffs' evidence is directed toward questioning the Directors' judgments about the surplus, in particular their judgment that the surplus was not at a level greater than what was appropriate for State Farm's operational needs." (*Id.*)

C. Appellants' Position Is Based On Unsupported Assumptions That Conflict With Settled Case Law

Appellants' complaint that the Board had to consider using surplus to pay additional dividends seeks exactly the kind of judicial second-guessing of an insurance company's decisions regarding its surplus that the courts are not equipped to make and have consistently declined to undertake. *E.g.*, *Lee*, 50 Cal.App.4th at 710-71; *Barnes v. State Farm Mut. Auto. Ins. Co.* (1993) 16 Cal.App.4th 365, 378-80.

Moreover, Appellants' claim that the Board was not "sufficiently informed" about using surplus to pay dividends is premised on the supposed "requirement" that a mutual insurance company's board must be supplied with an actuarial analysis setting forth the formulaic amount or

range of surplus that the company "needs"; and if the surplus exceeds the "needs" as determined by the actuarial analysis, the board must specifically consider using the excess to pay a dividend before using it for any other purpose. (AOB 20-25.)

Appellants do not cite a single reported case, statute, department of insurance regulation, standard, guideline, treatise, or article (scholarly or otherwise) that supports this "requirement."[2] Nor have Appellants offered any evidence that this is the way "well run" mutual insurance companies usually operate. In fact, Appellants have not identified even one instance where the board of any mutual insurance company (1) determined that the company had a "needed" level of surplus according to an actuarial analysis, determined the company had excess surplus over what it "needed" and then (2) deliberated about whether the "unneeded" portion of the surplus should

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[2] Appellants rely on sound-bite quotes from cases with no bearing on the Board's duties to State Farm's policyholders, such as cases analyzing how mutual companies needed to operate in order to qualify for an exemption under what used to be Federal tax law. *See Mutual Fire Ins. v. U.S.* (D.Pa. 1943) 50 F.Supp. 665 (AOB 22); *Keystone Mut. Cas. v. Driscoll* (W.D.Pa. 1942) 44 F.Supp. 658 (AOB 13); *Thompson v. White River Burial Ass'n* (8th Cir. 1950) 178 F.2d 954 (AOB 13, 24, 35); *National Chiropractic Ins. v. U.S.* (8th Cir. 1974) 494 F.2d 332 (AOB 32.) None of these cases addresses the business judgment rule or legal obligations of a mutual insurance company's board to its policyholders.

be paid out as a dividend.[3] This supposed actuarial analysis "requirement" was created solely for purposes of this litigation and exists only in the minds of two of Appellants' proffered "experts."

In addition, Appellants' supposed "requirement" is in direct conflict with this Court's finding that:

> [T]he insurance market is characterized by substantial diversity across insurers in types of business written, characteristics of customers, and methods of operation. It is impossible to specify the 'right' amount of [surplus] for most insurers through a formula. Each insurance company has its own method for determining the amount of surplus it considers to be adequate.

Hill II, 114 Cal.App.4th at 441 (citation omitted).

Appellants' actuarial needs "requirement" is also based on the assumption that State Farm's insureds had a reasonable expectation that they would receive larger dividends than what were actually declared. But Appellants are not investors in a stock company. As this Court found in *Hill II*, "State Farm does not offer insurance policies as investment opportunities but instead provides policyholders with protection against loss. In contrast, a stock insurance company seeks to earn a profit for the benefit of its stockholders, who may or may not be policyholders." *Id.* at 440.

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[3] As discussed below, the Board never determined the Company had "excess" surplus, so there was never any occasion for them to deliberate about what to do with "unneeded" surplus. *See infra* Part III.F.

Appellants' claimed dividend expectation also conflicts with this Court's explanation in *Lee* that people buy insurance policies like those at issue here with "the reasonable expectation . . . that he or she is purchasing insurance and *may*, in the *discretion of the Board*, receive dividends or other distributions." 50 Cal.App.4th at 723-24 (second emphasis added).

D. The Judgment Should Be Affirmed

The trial court granted summary judgment, finding that the Board's decisions regarding surplus were protected by the business judgment rule. The court found it unnecessary to reach State Farm's alternative ground for summary judgment: that the Board's power to declare dividends was wholly discretionary and could not be the subject of a breach of contract claim. (AA2-00345-348.) If, for any reason, this Court addresses this alternative ground for judgment, it will readily find that this discretionary power provides an independent basis for affirming the judgment below in State Farm's favor. (*Id.*; *see also* AA19-05246-5248.)

III. FACTUAL BACKGROUND

A. The Nature Of A Mutual Insurance Company

State Farm was incorporated in Illinois in 1922 under the Illinois Mutual Insurance Corporation Act of 1915. (AA2-00365 [UF:1].) Mutual insurance companies "do not generate traditional entrepreneurial profits, but rather seek to meet their obligations at the lowest possible cost to the policyholders . . . ." *Hill II*, 114 Cal.App.4th at 440 (quotations omitted)

(AA2-00365 [UF:2].) Policyholders of a mutual insurance company, like those of an interinsurance exchange, contract to receive insurance coverage "and may, in the discretion of the Board, receive dividends or other distributions." *See Lee*, 50 Cal.App.4th at 723-24.

B. Pertinent Policy Language

The "overwhelming majority" of the automobile insurance policies in question contain a single, short provision relating to dividends. (AA2-00365-66 [UF:5].) The provision states: "While this policy is in force, the first insured named in the declarations is entitled to . . . receive dividends the Board of Directors in its discretion may declare in accordance with reasonable classifications and groupings of policyholders established by such Board." (AA2-00365 [UF:4].)

C. State Farm's Directors

During the class period, State Farm's Directors included business leaders such as John Partee, Economist and retired Federal Reserve Board member, George Perry, Senior Fellow, The Brookings Institution, as well as other business leaders and deans and professors from America's leading business schools, law schools and universities, including Dr. James Wilson, Professor of Management and Public Policy, UCLA; Jerry Porras, Lane Professor of Organizational Behavior and Change, Stanford University; Professor W.H. Knight, Jr., Dean Emeritus and Professor, University of Washington School of Law and former Provost and Professor of Law,

University of Iowa; Dr. Robert Jaedicke, Professor and former Dean, Graduate School of Business, Stanford University; Curtis Tarr, Dean, Cornell University, Graduate School of Management; Burke Marshall, Professor, Yale Law School; and Robert Eckley, President, Illinois Wesleyan University. (AA19-05199.)

D. The Surplus Allowed State Farm To Lower The Price Of Its Insurance Policies

State Farm's goal is to charge the lowest possible premium for insurance while guaranteeing sufficient retained earnings to meet its responsibilities. (*See* AA5-1164:27-28.) It does not price its policies to generate an underwriting profit. (AA2-00365:9-14.) The Company prices its policies with the expectation of, at most, breaking even on the policy itself. As Dr. Wilson explained, "[t]ypically, we predicted we would earn nothing selling insurance." (AA2-00383:26; *see also* AA21-05913:12-13 ("I knew that the overall . . . profit goal was zero percent of the premium."), 05860:4-6.)

During the class period, State Farm priced its policies in a way that was designed to produce either no underwriting profit or even an underwriting loss. (AA5-01364:25-28 ("For example, beginning in 1998 State Farm Mutual reduced its target underwriting return for ratemaking purposes to *negative* five percent"), 01166:5-7, AA2-00381:19-23.) Invested income from the company's surplus made this possible. As Mr.

Joslin, State Farm's Chief Financial Officer explained, "[t]his enormous savings passed by State Farm Mutual to its policyholders simply would not have been possible without the financial strength provided by the growth of State Farm Mutual's surplus." (AA5-01365:2-6; *see also* AA5-01165:3-4, 01166:7-8, 01381:9-11.)

Similarly, State Farm's policies were not priced with the expectation of paying dividends. State Farm and its Board believed that its policyholders were seeking insurance protection at the lowest possible cost in the first instance. (AA5-01163:3.) As State Farm actuary Gregory Hayward testified, "State Farm develops its rate with no component or other calculation for a dividend in its rate calculations. . . ." (AA5-01163:3-5; *see also* AA2-00378:7-13.) During the class period, the Company considered and typically paid dividends only when underwriting income from the previous year exceeded original expectations. (AA2-00378:13-23, AA5-01363:1-5, 01382:6-9.) State Farm also utilized greater than expected underwriting income to reduce premiums. (AA2-00379:9-15; 00378:17-23, 00380:24-381:5.)

E. State Farm's Directors Made Surplus, Premium And Dividend Determinations On An Informed Basis And In Good Faith

The Board met every quarter in Bloomington, Illinois. (AA2-00368 [UF:18].) Director James Wilson of UCLA testified that State Farm's financial condition was the Board's "chief concern":

> Every board meeting begins with a very detailed examination of the financial circumstances of the company. In between board meetings, we receive monthly mailings about the financial circumstances. I would say that the financial condition of the company is probably the chief concern of the directors.

(AA2-00369 [UF:23].) Director Dr. Robert Jaedicke of Stanford further testified that the Board specifically discussed the Company's surplus at every meeting during his eight years on the Board, collectively examining and evaluating the fluctuations of the various surplus categories. (*Id.* [UF:25].)

Throughout the class period, the Board's review of State Farm's surplus and finances was continuous, in-depth and focused on every aspect of State Farm's financial condition, specifically including surplus, as is confirmed by a review of the information each Director received:

Monthly Financial Statements: Each month, the Directors reviewed a monthly financial statement setting forth the net worth of the company – including surplus and changes in surplus – and specifically examining each category of surplus as compared to the same time period from the prior year. (AA2-00369 [UF:26-27].) The Directors followed profits, losses, and the growth or contraction of surplus on a monthly basis. (*Id.* [UF:28].)

Quarterly Operations Reviews: Each quarter, the Directors received an Operations Review that provided a breakdown of each category

of State Farm's surplus, as well as a detailed description of State Farm's investment activities. (AA2-00370 [UF:29-31].)

Quarterly Financial Statements: The Directors also received Quarterly Financial Statements, which contained line-item detail regarding increases and decreases to surplus (including changes in each category). (AA2-00371 [UF:36-40].)

Quarterly "Consolidated Investment Activity" Reports: The Directors also received Quarterly "Consolidated Investment Activity" Reports, which reviewed the performance and composition of State Farm's investment portfolio during the previous three months. (AA2-00371-372 [UF:41-42].)

Annual Statements: Each year the Directors reviewed the Company's comprehensive Annual Statement, which was filed in every jurisdiction in which State Farm does business and subjected to intense regulatory scrutiny. (AA2-00372 [UF:43-45].) These Statements contained complete detail on surplus. (*Id.* [UF:46].)

Report on Audits of Financial Statements: Each year the Directors met and discussed the reports of the independent accountants who audited State Farm's Annual Statement. (AA2-00373 [UF:52].) Each year the auditors reported, without qualification, that the Statements "present[ed] fairly" the financial condition of the company and verified that State Farm's Annual Statement complied with the Statutory Accounting Practices

prescribed or permitted by Illinois law and the National Association of Insurance Commissioners ("NAIC").[4] (AA2-00374 [UF:54-57].)

Industry Group Reviews: The Directors also reviewed an Annual Financial Review of Selected Property & Casualty Insurance Groups, which annually compared State Farm's premium and surplus levels to other major insurers over a three-year period. (*Id.* [UF:58-59].)

Actuarial Opinions Regarding Loss Reserves: State Farm actuaries continuously reviewed and adjusted the Company's loss reserves. (AA2-00375 [UF:62].) Each year an independent certified actuary from Coopers & Lybrand also reviewed State Farm's loss reserves. (*Id.* [UF:63].) Beginning in 1992, the independent actuary annually confirmed the reasonableness and accuracy of reserves in a formal annual opinion provided to the Board. (*Id.* [UF:64].)

F. The Directors Affirmatively Determined That State Farm's Surplus Was Never Too High And Sometimes May Have Been Too Low To Achieve The Board's Multiple Goals

Based on their ongoing review of State Farm's financial condition, State Farm's Directors determined that the surplus was never excessive in light of the Company's threefold goals. (AA2-00376 [UF:72].) Dr. Wilson testified:

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[4] The NAIC "is the organization of insurance regulators from the 50 states, the District of Columbia and the five U.S. territories." *See* http://www.naic.org/index_about.htm.

> [W]e always were concerned that our retained earnings were high enough to meet [our] responsibilities.
>
> . . . . .
>
> There could be in principle "too much net worth." In my judgment, as a director for the seven or so years that I've been on the Board, we've never been in a position where we had too much. In fact, right now, I think we have too little.

(AA2-00377 [UF:73-74].) Dr. Jaedicke testified that during his eight-year tenure as a director:

> We considered the amount of the surplus as one element in assessing overall financial condition at almost every meeting . . . . As I indicated, I don't think there was ever a time when we were concerned that . . . we had too much.

(*Id.* [UF:75]; *see also* AA5-01380:3-20.)[5]

The Directors believed that, in addition to other purposes, its surplus provided an important margin of financial strength to best serve State Farm's present and future policyholders. (AA2-00377 [UF:76], AA5-01157:16-1158:9.) In considering State Farm's surplus, the Directors were "concerned with the long run financial health of the company." (AA21-05917:17-5919:17; AA12-03346 (Directors "measure[ed] time, not in the years . . . but in decades").) Accordingly, in considering the adequacy of

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[5] *See also* AA5-01362:7-11 ("At many of these [Board] meetings there were discussions regarding the 'appropriate' level of Surplus (capital) for this multi-line national insurance group. At no time did the Board reach a conclusion that the Surplus retained was in excess of reasonable limits."); AA21-05840:15-23 ("There were times when I did feel that State Farm didn't have as much surplus as I would like to have seen. . . . Sometimes the – I had greater concerns than others, I know. But I think it was pretty much throughout my time on – on the board, that I felt like that there – that I would have been comfortable with having even more surplus.")

the surplus, the Board "would look at [the surplus or net worth of the company] to make sure that number is high enough to support policyholders, now and in the future." (AA12-03325.) Moreover, in evaluating State Farm's surplus, the Board took into account the "volatile" nature of unrealized capital gains and the fact that "[w]hat is a gain one year could be a loss in the subsequent year." (AA21-06015-6017.)[6]

The Directors were aware during the class period that State Farm's premium-to-surplus ratio (one commonly used indicator of insurance company financial strength) was generally within industry averages. (AA2-00377 [UF:77].)[7] In no year during the class period did State Farm's premium-to-surplus ratio lead the industry and, from 1992 to 1997, it fell below the industry average, even though State Farm's actuaries believed that State Farm's risks required a larger-than-average surplus. (*Id.* [UF:78-79].)

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[6] Brian Atchinson, president of NAIC (*see supra*, n.4), described "investment risk" or "asset risk" as one of the primary risks to insurance company solvency that is taken into account by regulators in assessing the adequacy of an insurance company's surplus. Brian Atchinson, *The NAIC's Risk-Based Capital System*, 2 NAIC Research Quarterly 1-2 (1996).

[7] An insurer's premium-to-surplus ratio is a ratio that has the amount of net written premium as the numerator and the amount of surplus as the denominator. (AA5-01158:21-24 [Hayward Decl. ¶ 7].) Thus, a premium-to-surplus ratio of "2 to 1" means that for every two dollars of premium there exists one dollar of surplus. *Id.*

G. The Directors, Assisted By The Officers, Worked Continuously To Strike A Balance Between Additional Surplus, Lower Premiums And Dividends

State Farm's key executives and actuaries continuously monitored surplus levels, underwriting returns, loss trends and reserves, as well as other critical operating statistics. (AA2-00378-379 [UF:85].)

Throughout the class period, State Farm projected and adjusted its rates on a state-by-state basis. (AA2-00379 [UF:87-88].) During the class period, it repeatedly reduced the underwriting return target on its policies throughout the country. This translated directly into lower insurance rates for all policyholders either through reduced premiums or smaller increases in premiums. (*Id.* [UF:89].)

The Directors and Officers consistently determined throughout the class period that it would have been unwise for State Farm to liquidate any portion of its surplus for dividend purposes. (*Id.* [UF:90-91], AA5-01364:1-8.) Surplus was a critical factor in allowing State Farm to reduce its underwriting return targets and to lower insurance rates for its policyholders. (AA2-00380 [UF:92].) The strength of the surplus enabled State Farm to charge lower and more stable insurance rates than would otherwise have been possible. (*Id.* [UF:94], *see also* AA5-01383:25-1384:8.)

In light of the Northridge Earthquake and State Farm's underwriting performance in 1995 and 1996, the Board did not feel comfortable

declaring a dividend in those years. (AA2-00380 [UF:99]; AA5-01383.) Beginning in the fourth quarter of 1996, however, State Farm began reducing premiums significantly in a number of states where underwriting performance exceeded the underwriting target. (AA2-00380-81 [UF:100].) In 1997, the improved underwriting trend continued. (*Id.* [UF:101].) State Farm took advantage of the improvement by reducing premiums again, this time in 33 states, saving policyholders $437,000,000 in premium. (AA2-00381 [UF:101].)

By September 1997, the Board determined that underwriting improvements in a number of states and the Company's overall financial condition made a dividend appropriate in those states with a favorable performance, and declared a dividend of approximately $651,000,000. (*Id.* [UF:102].) Based upon its continued assessment for the remainder of 1997 and the first half of 1998, the Board declared an additional dividend of approximately $891,600,000 in June of 1998. (*Id.* [UF:103].)

The rate reductions collectively saved State Farm's policyholders billions of dollars in premiums. (AA2-00382 [UF:107].) In 1999 alone, State Farm was able "to reduce rates in 52 jurisdictions with a net reduction of $945 million in premiums." (*Id.* [UF:108]; *see also* AA5-01164:27-1166:21.)

H. The Board Declared 11 Dividends Totaling More Than $3.8 Billion Between 1983 And 2000

From 1983 through 2000 the Board declared eleven dividends to its auto policyholders totaling more than $3.8 billion, in the following approximate amounts:

Date	Dividend Amount
April 1983	$69,600,000
April 1984	$133,560,000
November 1987	$202,700,000
November 1988	$157,000,000
December 1991	$198,500,000
August 1992	$169,300,000
October 1993	$205,900,000
April 1994	$187,500,000
November 1997	$651,000,000
June 1998	$891,600,000
June 2000	$1,005,500,000
TOTAL	$3,872,160,000

(AA2-00383 [UF:110].) Furthermore, as noted, State Farm lowered premiums significantly during the class period. (*E.g.*, AA2-00379:9-15; 00378:17-23, 00380:24-381:5.) *Cf. also Penn Mut. Life Ins. v. Lederer* (1920) 252 U.S. 523, 528 ("Dividends may be made, and by many of the companies have been made largely, by way of abating or reducing the amount of the renewal premium.").

In the years when dividends were not declared, the Board evaluated State Farm's overall financial condition, including its surplus levels and underwriting returns and concluded that a dividend could not be supported. (AA2-00384 [UF:115].) The Board never believed it was prudent to

liquidate a portion of State Farm's stock portfolio to pay larger dividends. (AA2-00384-385 [UF:116-18].) Even the $1,005,500,000 dividend declared by the Board in June 2000 was paid out of State Farm's pre-tax operating income, which included underwriting profits and investment income but did not include unrealized capital gains on surplus. (AA2-00385-386 [UF:120-21].) State Farm's actuaries reported that State Farm's surplus was sufficient to permit this large dividend. (AA2-00386 [UF:123].)

Dr. Wilson testified that he evaluated these dividend recommendations based on the following principles:

> When we make a judgment about the financial condition of the company that we think may warrant a dividend, we . . . look at net income before taxes which combines any money we may have earned selling insurance plus payments to us in dividends and interest from our net worth.
>
> [We also] look at the net worth of the company taken as a whole, so that we can feel comfortable that should there be a series of catastrophes in th[e] near future, we would have enough money to pay all of the policyholders.

(AA2-00387 [UF:126].)

IV. LEGAL ARGUMENT

A. Standard Of Review

This Court reviews the trial court's decision to grant a motion for summary judgment de novo. *Guz v. Bechtel Nat'l* (2000) 24 Cal.4th 317, 334. Thus, this Court must determine whether State Farm met its burden of demonstrating that "'one or more elements'" of Appellants' case could not be established "or that 'there is a complete defense' thereto." *Aquilar v.*

Atlantic Richfield (2001) 25 Cal.4th 826, 850 (quoting Cal. Civ. Proc. Code § 437c(o)(2)). Appellants must identify specific, admissible evidence to show that there are triable issues of material fact. Cal. Civ. Proc. Code § 437c(p)(2). In addition, this Court is not restricted to affirming on the grounds stated by the trial judge and can "affirm the summary judgment . . . on any legal ground applicable to this case. . . ." *Medill v. Westport Ins.* (2006) 143 Cal.App.4th 819, 827-28.

A trial court's exclusion of expert testimony "will not be disturbed on appeal unless a manifest abuse of that discretion is shown." *Redevelopment Agency v. First Christian Church* (1983) 140 Cal.App.3d 690, 702-03.

B. The Business Judgment Rule

As this Court found in *Hill II*: the '"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.'" 114 Cal.App.4th at 450 (citation omitted). Decisions regarding an insurer's surplus, including decisions whether or not to declare a dividend, "rest[] wholly in the business judgment of the board of directors," and a court is not empowered to "substitute its judgment for that of [directors] actively engaged in business in the community." *Id.* Under Illinois law, the business judgment rule protects decisions not only by a corporation's board of directors, but

also by its officers and management. *Selcke v. Bove* (Ill.Ct.App. 1994) 629 N.E.2d 747, 750.

A court may not interfere with the exercise of the directors' business judgment with regard to dividends "unless the withholding [of a dividend] is fraudulent, oppressive, or totally without merit." *Romanik v. Lurie Home Supply Ctr.* (Ill.Ct.App. 1982) 435 N.E.2d 712, 723. The party challenging a corporation's decisions regarding dividends has the burden of rebutting the presumption that the company's board and management acted in good faith by presenting evidence showing "fraud, oppression, dishonesty, total lack of merit, illegality, or a failure of the board of directors to become sufficiently informed to make an independent decision. . . ." *Hill II*, 114 Cal.App.4th at 451. Absent one of these exceptions, a corporation "is not liable for a lack of dividends." *Id.*

C. Appellants Have Failed To Establish A Triable Issue Of Material Fact As To Whether The Board's Surplus Decisions Were Adequately Informed

Despite the wealth of financial information that was provided to the Board on a monthly, quarterly and annual basis, *see supra* Part III.E, Appellants claim that the Board's management of its surplus is not protected by the business judgment rule because the Board was never supplied with the "actuarial analysis required for an informed judgment as to State Farm's surplus needs." (AOB 19.) According to Appellants, State Farm's Board "required" an actuarial analysis that would tell them how

much surplus State Farm "needed." (*Id.* at 21.) This assertion is, of course, in direct conflict with this Court's observation 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 440-41.

The undisputed evidence is that the Board and management properly and correctly regarded the question of how much surplus State Farm "needed" as a question for the Board that could not be determined simply on an actuarial basis. Rather, State Farm's officers and Directors constantly considered numerous factors, including not only State Farm's underwriting risks, but also the makeup of the surplus, current and projected future business needs, financial risks and considerations, including the possibility of inflation and stock market losses, and the desirability of more stable and lower insurance rates and premiums. (*E.g.*, AA12-03233 (State Farm actuary Gary Grant testified that whether State Farm had adequate surplus "wasn't a conclusion that I would draw. That's a conclusion that would be drawn by the board of directors . . . ."); AA12-03221-3227, AA13-03647-3672.)

Appellants also incorrectly suggest that State Farm's actuaries did not analyze State Farm's surplus. (*E.g.*, AOB 21-22.) In addition to the formal actuarial analysis completed by State Farm's actuaries in 2000, which concluded that State Farm's surplus was neither excessive nor inadequate, (AA5-01169), State Farm's actuaries performed a similar

analysis every year. Actuary Greg Hayward testified that State Farm's Actuarial Department "continuously analyzed" surplus, although those analyses were not reduced to writing. (AA5-01157:16-1158:19.) "Each year, [State Farm's] Actuarial Department advised executive management about the level and adequacy of Surplus, and . . . based on the Actuarial Department's analysis and review, it had concluded that the size of State Farm Mutual's surplus was reasonable and not excessive." (AA5-01158:12-14.)

Moreover, as Appellants concede, Illinois law requires only that directors make such reasonable inquiry as an ordinarily prudent person under similar circumstances. (AOB 20.) Yet, Appellants have made no showing that any ordinarily prudent board of directors of a mutual insurance company has ever asked for an actuarial analysis setting an "appropriate" or "necessary" range of surplus that the company should not exceed. Appellants do not contend that the Illinois insurance department or any other insurance regulatory body requires or recommends that mutual insurers perform such an analysis. Appellants do not cite any statute or regulation or judicial decision that requires such an analysis.[8]

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[8] As the trial court recognized, moreover, "the amount of information that it is prudent to have before a decision is made is itself a business judgment of the very type that courts are institutionally poorly equipped to make." (MSJ Op. 15 (quoting *In re RJR Nabisco, Inc. Shareholder Litig.* (Del.Ch. 1989) 1989Ch.LEXIS 9, *57-58).) *Stamp v. Touche Ross & Co.* *(cont'd)*

Likewise, Appellants wrongly rely on *Ford v. Ford Mfg. Co.* (1921) 222 Ill.App. 76 (AOB 8), which did not involve the duties of a mutual insurance company's board. Rather, the court addressed whether a former stockholder of a for-profit corporation was entitled to a dividend that was declared while he owned stock, but paid after he sold the stock to the defendant. *Penn Mutual,* 252 U.S. 523 (AOB 21) was a tax case analyzing whether certain dividend payments should have been included in the taxpayer's gross income. The taxpayer was a legal reserve company that sold life insurance policies as investment opportunities. *Id.* at 534. *Cf. Hill II*, 114 Cal.App.4th at 440 ("State Farm does not offer insurance policies as investment opportunities but instead provides policyholders with protection against loss."). Last, *Lipsman v. Reich* (N.Y.Misc. 1939) 173 Misc. 294, (AOB 21), rejected as a matter of law policyholders' attempts to compel further dividends out of the company's surplus, noting the board's valid business concerns about "unexpected losses" and the "importance of conserving the assets" in casualty lines. 173 Misc. at 297.

Contrary to Appellants' arguments, the fact that State Farm's actuaries did not provide the Board each year with a formal written analysis

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(2003) 263 Ill.App.3d 1010, 1016, which Appellants cite in an attempt to distinguish *RJR Nabisco* (AOB 20), in no way suggests that State Farm's Directors lacked any information they required to make informed decisions about the Company's surplus.

setting forth a "range" within which State Farm's surplus should fall does not impugn the Board's decisions concerning the Company's financial needs or defeat the operation of the business judgment rule.

D. Appellants Have Failed To Establish A Triable Issue Of Material Fact As To Whether The Board Properly Deliberated Its Decisions Concerning Surplus

Appellants cite a number of cases for the principle that the business judgment rule does not protect decisions made without deliberation and an exercise of judgment. (AOB 10-11.) While this is a correct statement of the business judgment rule, none of those cases is remotely similar to this case. As the trial court correctly found, the Board deliberated extensively about its uses of surplus. (MSJ Op. 4-5, 11-22. *See also supra* Parts III.F-G.)

For example, in *RSL Communications v. Bildirici* (S.D.N.Y. Sept. 14, 2006) 2006 WL2689869, *6, (AOB 10) it was "undisputed that the Defendants did not hold board meetings" during the relevant time period and that there was "*no* independent board discussion" of material business decisions made on behalf of the company. *Id.* (emphasis added). The court concluded that the business judgment rule "does not tolerate inaction of the sort Defendants are alleged to have engaged in, as Defendants allegedly failed to consider *any* information they had regarding the company's financial health and allegedly failed to make a business judgment as a board regarding *any* financial decision . . . ." *Id.* Notably, the decisions at issue

in *RSL* were not a long-term series of decisions in the normal course of the company's affairs (like those at issue here), but a short-term series of "material decisions" that were "made in the absence of *any* information and *any* deliberation" and which authorized "precisely the type of conduct which the courts have held is proscribed for a corporation operating in the vicinity of insolvency: 'transactions, usually without fair consideration to the company, for the benefit of the parent corporation or related entities.'" *See In re RSL Com Primecall* (Bankr. S.D.N.Y. Dec. 11, 2003) 2003 WL22989669, *12 (AOB 10).

Appellants claim that the business judgment rule "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." (AOB 10 (citing *Silver v. Allard* (N.D.Ill. 1998) 16 F.Supp.2d 966, 970).) Again, this is a correct statement of the business judgment rule, but it has no application here. Neither *Silver* nor the business judgment rule stands for the proposition that a course of conduct like that at issue here could or should be deemed a circumstance in which the Board "absent a conscious decision, failed to act."

State Farm's Board continuously examined the Company's financial condition and surplus, and determined that the surplus was not excessive and should be larger. *See supra* Parts III.E-G. The Board affirmatively decided that surplus should be retained and not liquidated because the

surplus served the three important purposes of protecting against catastrophic loss, providing for growth, and enabling lower and more stable premiums. *Id.* Indeed, Appellants cite no case that would support characterizing the Board's judgments about State Farm's surplus as lacking a conscious decision.[9]

1. Director Vincent Trosino's Testimony Does Not Establish A Triable Issue Of Material Fact

Appellants argue that Director Vincent Trosino's statement that the Board had "not considered dividending out surplus for the purpose of paying a dividend," is an admission that the Board as a whole did not make informed decisions concerning the amount and uses of surplus. (AA10-02911-2912 (cited at AOB 5).) This is simply another example of Appellants' attempt to shift the focus from a case about rational and informed surplus decisions to a case about use of surplus for only one possible purpose: payment of dividends. However, the question under the

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[9] Citing *Blasius Indus. v. Atlas Corp.* (Del.Ch. 1988) 564 A.2d 651 and *Hilton Hotels v. ITT Corp.* (D.Nev. 1997) 978 F.Supp. 1342, Appellants also suggest that the business judgment rule presumption should be relaxed here because State Farm's by-laws made it "virtually impossible" for them to elect board members to advance their interests. AOB 2, 32n.10. *Blasius* and *Hilton* each address an exception to the business judgment rule where the challenged board decision directly interferes with existing stockholder voting rights. Appellants make no contention that the Board's surplus decisions interfered with their voting rights. Nor do they challenge the company's by-laws. That the by-laws require policyholders to follow certain procedures when seeking to elect board members is not a basis for ignoring the business judgment rule with respect to the Board's surplus decisions.

rule is whether the Board made *a* rational and informed decision about the amount and uses of surplus, not whether the Board considered and deliberated about *all* potential uses of surplus that any of State Farm's millions of policyholders might have preferred.

Not considering "selling off surplus for the purpose of paying a dividend" is but one of an endless list of "not considereds" that could be conjured up, like not investing in Beverly Hills real estate or not diversifying into high-tech industries. What controls is whether what the Board *did* consider – use of surplus to sustain growth, lower premiums, and insure against catastrophic losses – resulted in rational and informed decisions.[10]

Mr. Trosino's deposition testimony demonstrates that State Farm's policy of generally awarding dividends only out of underwriting profit was both rational and informed. As Mr. Trosino explained, the Board's "model" was:

> to provide for our policyholders at the lowest cost possible a policy contract that will live up to our obligations to pay them and that we will have the wherewithal to do that come what

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[10] Appellants misleadingly contend that certain "[i]nternal State Farm documents show concern about the size of the surplus." (AOB 8.) In fact, the documents address the reasons State Farm needed a stronger surplus than many other insurers. (AA12-03221-3227, AA13-03647-3672 (1991 internal memoranda discussing, *inter alia*, inability of mutual companies to raise capital by issuing stock and risk that catastrophes would cause decline in value of assets).)

> may. And in doing so, as a mutual company where we only raise our capital through retained earnings or build our capital through retained earnings, we believe our surplus position has to be very, very strong. And that has served us well for over 80 years and being the number one insurer of automobiles and having the highest retention rate of any large company. I think it's – the model we have has proven to be successful with our policyholders. (AA10-02911.)

Like State Farm's other Directors, Mr. Trosino concluded that State Farm's surplus was never excessive in relation to the insurance risks and business needs of State Farm. (AA5-01380:7-10 ("In my judgment as a Director and Officer of State Farm Mutual, State Farm Mutual's Surplus was never excessive. At no time during my tenure as a Director, did I believe that State Farm Mutual was overcapitalized, nor did I believe that State Farm Mutual had 'too much' Surplus.").)

Appellants assert that the Board followed an "unchanging practice" of declaring dividends only when actual results exceeded "underwriting target income." (AOB 15.) First, despite Appellants' attempts to characterize "unchanging" as a pejorative, the business judgment rule does not penalize a board that *consistently* follows a rational and informed policy. *Matter of Reading Co.* (3d Cir. 1983) 711 F.2d 509, 517-20 (business judgment rule protected the board's unchanging decision never to declare dividends to the member-owners of a rail car leasing company).

Second, although State Farm generally paid dividends only when underwriting performance was better than projected, there was "no

evidence" of a "rigid policy" of *never* awarding dividends from surplus and current investment income. (MSJ Op. 25.) Rather, the evidence plainly showed that the Board carefully considered State Farm's financial condition, including its surplus and investment income, at every meeting. *See supra* Parts III.E-F. The Board decided that surplus should be retained and allowed to grow. *Id.* State Farm generally paid dividends from unanticipated underwriting income and, at times, from investment income. (*See* AA13-03741-3747; *see also* AA22-06037-6042.) In addition, in some years (1992, 1993, and 1994), the Board declared dividends in periods of underwriting loss. (*See* AA22-06039-6040.) What was not done was liquidating surplus to pay a dividend.

2. Director Wendy Gramm's Testimony Does Not Establish A Triable Issue Of Material Fact

Appellants incorrectly assert that the testimony of a single former Board member, Wendy Gramm, an economist and the former Chief of the Commodity Futures Trading Commission, creates a question of fact regarding the Board's deliberation of using surplus to reduce premiums. (AOB 18.) Ms. Gramm testified at deposition that she did not remember a written or oral presentation to the Board regarding a rate reduction in lieu of dividends. (*See id.*)

First, once again, for purposes of the business judgment rule, the question is what the Board did do, not all of the things that it could have

done but did not do. Second, the failure of one former Board member, who left the Board approximately three years before she testified, (AA12-03662-3663 [16:22-17:4]), to remember a particular presentation on a particular topic is not evidence that such a presentation did not occur. It simply means she could not remember. *See, e.g., Sigall-Drakulich v. Columbus* (6th Cir. Dec. 14, 2005) 2005 WL3419995, *7 (affirming summary judgment stating that witness' failure to recall "whether the committee discussed Plaintiff's lack of diplomacy" did not raise question of fact as to whether plaintiff's lack of diplomacy was considered in denying promotion); *Miller v. Illinois Central RR Co.* (7th Cir. 2007) 474 F.3d 951, 953-54 (affirming summary judgment for defendant; testimony that witness "did not recall hearing" train whistle did not raise question of fact as to accuracy of testimony of other witnesses that whistle had been blown).

In any case, although Ms. Gramm did not remember a presentation specifically regarding the use of surplus to reduce premiums *in lieu of dividends*, she was certainly aware of the fact that the growth in State Farm's surplus allowed State Farm to achieve significant reductions in premiums. (AA12-03383-3384.)

Thus, Ms. Gramm's lack of memory does not controvert the consistent testimony of other Officers and Directors that they were cognizant of and discussed the relationship of the surplus and earnings to reducing premiums and/or paying dividends. For example, Dr. Wilson

recalled senior management reporting to the Board that "[w]e had done better than we expected in selling insurance and that we had two choices: [o]ne was either to try to lower the prices we charged for our policies, the other was to declare a dividend or possibly to do both simultaneously." (AA2-00378:17-23; *see also* AA21-06010:18-25.)

Mr. Trosino confirmed both the connection between the growth in State Farm's surplus and State Farm's ability to charge lower premiums and the Board's consideration of that connection. He testified that

> [t]he Board determined that it was in the best interests of our policyholders to continue the growth of this Surplus both to enhance our financial strength and ability to pay claims in the long term and to enhance our ability to charge and to continue to charge lower rates and premiums than would otherwise have been possible. Throughout this time frame, the presence and growth of our Surplus enhanced our ability to maintain these rates and to implement rate reductions.

(AA5-01384:1-6; *see also* AA2-00382:2-4.)

Director Jaedicke similarly testified that, in the Board's consideration of dividends and the appropriateness of State Farm's surplus, the Board took into account the use of the surplus to allow State Farm to maintain and/or reduce premiums. Dr. Jaedicke testified about his understanding that the process that led to management recommending a dividend included management's "continually reviewing the rate structure" "to try to be sure that the rate structure that you had in effect was achieving the goals that you had, the objective – the profit objective that you had set."

(AA21-05911:11-23.) According to Dr. Jaedicke, that process of continual analysis could result in proposed rate revisions, a recommended dividend, or both. (AA21-05912:1-8; *see also* AA21-05913:24-5914:3.) Dr. Jaedicke went on to explain that

> reducing the underwriting goal to a minus five percent of premiums . . . should result to policyholders as a benefit and to incur a – to set a goal of a five percent underwriting loss of five percent, means that you're using the financial strength that [you] have – that you're using the financial strength that you're gaining through the investment program. So that's one way to – that – that's a pretty big step in terms of returning benefits to the policyholders in the form of lower rates.

(AA21-05932:15-25. *See also* AA21-05870:4-5871:17 ("the strength of the Surplus enables [State Farm] to charge lower and more stable insurance rates than would otherwise be possible").)

Appellants also assert that Ms. Gramm's testimony shows that State Farm's "rate reductions were responses to competitive and marketing pressures." (AOB 19.) Taking competitive and marketing factors into account in pricing insurance policies is hardly the kind of uninformed or irrational decision that would overcome the business judgment rule presumption. It is the exercise of good business judgment. Moreover, in the testimony cited by Appellants, Ms. Gramm stated that the rate reduction discussion addressed *both* "competitiveness and providing value to . . . customers." (AA12-03384.)

Likewise, State Farm's rate filings with state regulatory agencies do not create a triable issue of fact on this topic. (AOB 19.) Appellants misstate the issue when they contend that State Farm's filings "give no indication that rate reductions were intended to return excess surplus to policyholders." *Id.* The rate filings provide specialized rate calculations that enable regulatory bodies to judge whether rates are acceptable. As Mr. Hayward testified, it is customary and expected for insurers to base rate filings not on actual surplus, but on a hypothetical minimum figure, and doing so results in lower rates. (*See* AA21-05876:7-10.)

In short, the testimony of Ms. Gramm, Dr. Wilson, Dr. Jaedicke, Mr. Trosino, Mr. Hayward and others makes clear that the Board was well aware that State Farm's strong surplus benefited policyholders. Their testimony shows that surplus helped make possible more stable rates and the rate reductions that occurred during the class period, and these desired results entered into the Board's analysis and determinations regarding the propriety of State Farm's surplus.

3. Appellants' Claim That The Trial Court Relied Entirely On Statements Of Individual Directors Does Not Establish A Triable Issue Of Material Fact

Appellants claim the trial court relied on evidence that reflects only the statements of "individual directors" as to their belief that State Farm's net worth was if anything too small. (AOB 18.) In fact, Appellants present

no evidence to support their assertion. The uncontradicted evidence reflects that the Board as a whole had "discussions regarding the 'appropriate' level of Surplus (capital) for this multi-line national insurance group" and that "[a]t no time did the Board reach a conclusion that the Surplus retained was in excess of reasonable limits." (AA5-01362:7-11.) The testimony of Directors Jaedicke and Wilson, quoted above, clearly describes not just the personal view of these individual Directors, but the judgment of the Board as a whole. (*See, e.g.,* AA2-00377:1-3 ("*we* always were concerned that our retained earnings were high enough to meet [our] responsibilities") (emphasis added); (AA2-00377 [UF:75]) ("I do not think there was ever a time when *we* were concerned that . . . we had too much.") (emphasis added).)

4. The Contents Of The Board Minutes Do Not Establish A Triable Issue Of Material Fact

Appellants contend that the absence of a specific reference in the minutes of the Board's consideration and adoption of the plan whereby dividends were declared only in the event of better-than-expected underwriting performance means that the Board never gave adequate consideration to the use of surplus to pay dividends. (AOB 15-16.)

Again, as has been discussed, the issue is what the Board did consider, not all the other things it could have considered. The minutes affirmatively reflect the close attention devoted by State Farm's Board to all

matters affecting the Company's financial health. (*E.g.*, AA14-03817.) *See also* Parts III.E-G, *supra*.

In addition, Board meeting minutes are brief summaries of long meetings; they are not required or intended to record all the documents and analyses provided to the Board or to record the content of all discussions at meetings, and it is not required that they do so. *See, e.g., Field v. Oberwortmann* (Ill.Ct.App. 1958) 148 N.E.2d 600, 601-02 ("[I]n recording the minutes of a director's meeting, the secretary, though under an obligation to keep the minutes 'faithfully,' is not obligated to include everything that is said in the minutes as long as he accurately transcribes what has taken place." (citation omitted).)

The minutes are not evidence that the Board did not properly deliberate on dividends, surplus, operational performance or any other matters, and do not create a question of fact concerning the Board's deliberations.

E. Appellants Have Failed To Establish A Triable Issue Of Material Fact As To Whether The Board "Rubber-Stamped" The Dividend Recommendations Of Management

Appellants claim that the Board merely "rubber-stamped" the *dividend* recommendations of management. (AOB 16-18.) Once again, Appellants do not challenge the Board's decisions regarding the amount and uses of *surplus*. Moreover, the evidence reflects that the Board engaged in

intensive discussion and questioning before voting on management's dividend recommendations. *See supra* Parts III.E-F.

The decisions cited by Appellants actually confirm that what occurred at State Farm's board meetings did not even come close to falling into the category of "rubber-stamping."

For example, in *Davidowitz v. Edelman*, (AOB 16) the board's special litigation committee was composed of persons whose dual relationships and business interests "create[d] an inherent conflict of interest"; the committee "did not join in their counsel's investigation or review, save in the most perfunctory manner." (N.Y.Sup.Ct. 1992.) 583 N.Y.S.2d 340, 344, *aff'd*, (N.Y.App.Div. 1994) 612 N.Y.S.2d 882. Likewise, *Chapin v. Benwood Found.* (Del.Ch. 1979) 402 A.2d 1205, (AOB 16) has no relevance to Appellants' contention that the Board merely rubber-stamped management's recommendations. In *Chapin*, the court refused to enforce a written agreement entered into by a nonprofit organization's trustees relinquishing their duty to appoint new trustees. *Id.* at 1210. Appellants' citation to *Gaillard v. Natomas Co.* (1989) 208 Cal.App.3d 1250 is similarly misplaced. (AOB 20.) *Gaillard* involved board members who worked together to enrich each other through "golden parachute" arrangements with no valid business purpose. *Id.* at 1269-70.

Indeed, the courts have made clear that "rubber-stamping" and/or "inattention" require evidence that the directors "'consciously and

intentionally' disregarded their responsibilities and adopted a 'we don't care about the risks' attitude regarding a material corporate decision" or that directors employed "a grossly negligent process" in reaching their decisions. *In re Tower Air* (3d Cir. 2005) 416 F.3d 229, 240.

Appellants charge that the Board approved management's recommendations of dividends based upon a one-page "worksheet" without modification or consideration of alternatives. (AOB 16.) In the testimony cited by Appellants (AA12-03324), Director Dr. Wilson actually states that the Board voted for dividends "after considerable discussion" and that the Board "would look at, typically, the returns for the last half of the preceding year and the first half which would necessarily be unaudited returns for the year in which we voted [the dividend]," and "would look at the 12-month period to see if the company appeared financially healthy enough to justify a dividend." (*Id.*) Dr. Wilson also noted that the Board would have received in advance "monthly financial statements, and quarterly financial statements" and that "on the occasion of the meeting, one of the chief financial officers would give an overview of the company for the preceding, depending on the accuracy of their figures at the moment, nine to ten months." *Id.* The rest of Dr. Wilson's testimony further evidences the extent of the consideration and discussion on the part of board members in deciding to approve a dividend. (*E.g.*, AA12-03325-3326.)

Appellants claim that the supposed "long gap periods" between dividends are evidence of "periodic inattention" on the part of the Board that somehow "creates a triable issue of fact as to whether State Farm has forfeited business judgment rule's [sic] protection, at least for the long gaps." (AOB 17-18.) This assertion is undermined by the uncontested evidence that the Board members reviewed constant updates concerning the Company's financial position. *See supra* Part III.E-F. Appellants cite no legal authority that supports the proposition that a mutual automobile insurance company's directors must consider dividends at fixed intervals or must consider paying them during time periods when they believe that the company's surplus should be larger.[11]

F. Appellants Have Failed To Establish A Triable Issue Of Material Fact Under The "Totally Without Merit" Exception To The Business Judgment Rule

Appellants assert that the Board's *dividend* – not its *surplus* – decisions were totally without merit. (AOB 33-42.) To establish the "totally without merit" exception to the business judgment rule, a plaintiff must show that the decision cannot be "attributed to any rational business purpose." *Matter of Reading Co.* (3d Cir. 1983) 711 F.2d 509, 517 (quoted

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[11] *Coons v. Home Life Ins.* (Ill. 1938) 13 N.E.2d 482, does not support Appellants' contentions. (AOB 17.) In *Coons*, the court rejected a policyholder's claim that she was entitled to receive an early dividend. *Coons* does not purport to impose a duty on automobile insurance companies to deliberate on or pay dividends at fixed intervals.

in *Hill II*, 114 Cal.App.4th at 445); *see also Romanik*, 435 N.E.2d at 723 (upholding board's decision not to declare dividends under Illinois business judgment rule where "several business reasons" justified the decision); *Silver*, 16 F.Supp.2d at 970 (business judgment rule protected board where plaintiff did not show that the challenged transactions "were 'devoid of a legitimate corporate purpose'"). Here, Appellants' reliance upon the *ipse dixit* pronouncements of their proposed expert that State Farm's Board's decisions concerning surplus were completely without merit does not suffice to overcome the business judgment rule. The record clearly reveals that those decisions had rational business purposes. (*E.g.*, AA12-03324.)

Significantly, this Court's discussion of whether a board's course of conduct can be "attributed to any rational business purpose" in *Hill II* relied heavily on *Nedlloyd Lines v. Superior Court* (1992) 3 Cal.4th 459, which, in turn, relied on *Matter of Reading Co.* (3rd Cir. 1983) 711 F.2d 509, 517-20. *See Hill II*, 114 Cal.App.4th at 444-45.

Reading arose out of the bankruptcy of a railroad, which was a stockholder in Trailer Train. Trailer Train was formed by a number of railroads to establish a pool of standardized rail-cars that the shareholder railroads used. Trailer Train's contracts with the railroads provided that "Trailer Train would charge users of pool cars the lowest possible car hire rates, and would not accumulate surplus earnings or profits from which pro rata dividends could be paid." 711 F.2d at 519.

When Reading went bankrupt, it ceased to operate as a railroad and, therefore, received no benefit from its ownership of Trailer Train stock. Reading's bankruptcy trustees petitioned for an order compelling Trailer Train to repurchase the stock or pay dividends. The District Court found that Trailer Train had breached its fiduciary obligations to Reading and ordered Reading's stock to be repurchased at book value. The Third Circuit reversed, noting that Reading's contract with Trailer Train provided that pool car users would be charged the lowest possible rate and that Trailer Train would not accumulate surplus earnings from which dividends could be paid. Accordingly, Reading was receiving exactly what it bargained for when it purchased the shares. *Id.* at 519.[12]

The court went on to explain that the board is given the benefit of the doubt when a course of conduct is reviewed under the business judgment rule, particularly where that course of conduct has been successful:

> Each of the challenged policies can be attributed to a rational business purpose. Trailer Train's car leasing policy, by setting the lowest possible car hire rates, presumably keeps demand for the cars high. The refusal to pay dividends could help achieve that goal by eliminating the need to raise rates to earn a surplus. The reinvestment of earnings in new

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[12] This holding directly contradicts Appellants' sweeping assertion that "[i]f 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 earning." (AOB 13.)

> equipment assumedly helps Trailer Train meet the flat car needs of its customers. Indeed, under the challenged policies Trailer Train has undergone remarkable growth. [*Id.* at 520.]

As *Reading* and countless other cases make clear, the business judgment rule does not require that a board do what any given plaintiff decides in hindsight should have been done. Rather, the rule requires only that the board's relevant conduct be rational, with all doubts resolved in favor of the finding of rationality. *Id. See also Hill II*, 114 Cal.App.4th at 450-51.

Here, as the trial court correctly found, State Farm's overall approach concerning the amount, and uses, of surplus as well as the exercise of its discretionary right to declare dividends, easily met the rationality test as a matter of law. (MSJ Op. 6-10.) In that regard, it cannot be overemphasized that, as in *Reading*, this is not a case where the defendants are attempting to avoid liability for some economic disaster on the grounds that their mistakes "seemed like a good idea at the time." Here, it is clear, especially with 20/20 hindsight, that the surplus decisions in question were not only rational, they were highly successful.

Thus, the trial court correctly rejected Appellants' contention that the Board's decisions were "so irrational as to be 'totally without merit.'" (*Id.* at 11.)

G. Appellants Failed To Establish A Triable Issue Of Material Fact Under The Fraud Exception To The Business Judgment Rule

Appellants argue that the Board failed to disclose that it "excluded surplus from dividend consideration" and that the Board gave policyholders "comprehensively deceptive Annual Reports that consistently concealed, diminished and downplayed the surplus." (AOB 42.) As the trial court correctly held: "These arguments miss the point and would not establish an exception to the business judgment rule even if plaintiffs' contentions were supported by admissible evidence." (MSJ Op. 23.)

1. Appellants' Fraud Claims Have Nothing To Do With The Board's Decisions Concerning Amount And Uses Of Surplus

The instances of "fraud" alleged by Appellants are unrelated to the Board's decisions regarding amount or uses of surplus. (*Id.* at 23.) As the trial court ruled, Appellants failed to offer evidence

> that links this summary to the Board's decisions concerning dividends and surplus in a way that could cast doubt on the good faith of the Directors making those decisions. Plaintiffs do not offer evidence that this communication was from the Board of Directors or was approved by the Board.

(*Id.* at 24.) Thus, none of Appellants' assertions of fraud, even if accurate, would rebut the presumption that State Farm's directors "ma[d]e [their surplus] 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" or would show that "the director[s] acted fraudulently, illegally, or without

becoming sufficiently informed to make an independent business decision." *Ferris Elevator* (Ill.Ct.App. 1996) 674 N.E.2d 449, 452.

Appellants now argue that the inserts named the Board members and "were issued over the signature of the company's Board Chairman." (AOB 49.) In fact, the inserts are identified as coming from State Farm (*e.g.*, AA13-03503-3508) and the enclosed list of Directors in no way indicated or conveyed that the Directors were responsible for the inserts' content. Nor did the inclusion of a message from Ed Rust, Jr., State Farm's C.E.O. and Chairman, transform the inserts into director communications.

None of the cases cited by Appellants supports treating the financial summaries in State Farm's inserts as "director communications." Most of Appellants' cases do not even address the fraud exception to the business judgment rule.[13] The few that do hold only that, when *directors*

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[13] *See Reliance Sec. Litig.* (D.Del. 2001) 135 F.Supp.2d 480, 491 (SEC filings signed by responsible directors); *In re Ill. Valley Acceptance* (C.D.Ill. 1982) 531 F.Supp. 737, 740 (loan transaction personally approved by conflicted board members). The other cases cited by Appellants are also inapposite. E.*g.*, *F.H. Hill v. Barmore* (1920) 220 Ill.App. 222 (rejecting company's attempt to recover money paid over time to the wife of deceased president, stating that directors were chargeable with knowledge of the payments recorded on company's books); *F.D.I.C. v. Lauterbach* (7th Cir. 1980) 626 F.2d 1327, 1337 (rejecting fraud claim brought *by* company's directors against FDIC because directors knew of alleged fraudulent transactions); and *Hoye v. Meek* (10th Cir. 1986) 795 F.2d 893, 896 (involving a director who (unlike here) failed to monitor company's financial activities). *Kelly v. Bell* (Del.Ch. 1969) 254 A.2d 62, did not address the question of whether annual reports constitute director communications, merely holding that the communications at issue were not

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"communicate publicly or directly" with shareholders, they must do so honestly. *See Malone v. Brincat* (Del. 1998) 722 A.2d 5, 10; *Marhart, Inc. v. CalMat* (Del.Ch. Apr. 22, 1992) 1992 Del.Ch.LEXIS 85. These cases do not support treating communications from the company as director communications that could be relevant to the fraud exception.

2. The Bases For The Board's Surplus-Usage Decisions Were Fully Disclosed To Policyholders

Appellants argue that the fraud exception applies because the Board did not disclose its alleged "policy" of excluding surplus from dividend consideration. (AOB 43.)

First, the supposed fraud was unrelated to the Board's uses and maintenance of its surplus, including its decisions regarding dividends.[14]

Second, as the trial court correctly found, no such rigid "policy" regarding dividends existed at State Farm. (MSJ Op. 25.) Rather, the undisputed evidence is that throughout the class period, the Board continuously evaluated the Company's surplus and affirmatively

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fraudulent. Likewise, *Parish v. Md. & Va. Milk Producers* (Md. 1968) 242 A.2d 512, 544, did not address when/whether communications may be attributed to board members.

[14] Under Illinois law, non-disclosure is not fraudulent absent a duty to disclose. *Connick v. Suzuki Motor* (Ill. 1996) 675 N.E.2d 584, 593. *Winger v. Richards-Wilcox Mfg.* (Ill.Ct.App. 1961) 178 N.E.2d 659, 661-62 (AOB 43), involved a mandamus action to enforce the plaintiffs' *statutory right* to examine the company's books.

determined that it was not excessive and should be larger. *See supra* Part III.E-G. Thus, as the trial court recognized: "there is no basis for Plaintiff's argument that State Farm should have made a disclosure that the company had decided never to declare dividends from surplus, because the Directors never made such a decision . . . ." (MSJ Op. 25.)

Third, as the trial court correctly held, the undisputed evidence shows that "State Farm shareholders were correctly informed of the basis on which dividends were being calculated." (*Id.* 25 n.7.) During the class period, State Farm repeatedly apprised policyholders of the Board's dividend approach in a given year, which typically was to issue dividends where the Company's underwriting results were better than expected. (*See, e.g.*, AA22-06179, AA13-03513-3515, 03522-3524, 03530.) Additional State Farm reports to policyholders also reflect State Farm's dividend policy to pay dividends in recognition of lower-than-expected claims costs. (*See, e.g.*, AA11-02967-2969, AA22-06163, 06167.)

3. The Financial Summary Inserts Were Not Misleading

As noted above, the one-page inserts, which Appellants refer to as "Annual Reports," are included with policyholder premium invoices. The inserts contain a brief summary of financial information, including a listing of the assets comprising State Farm's policyholder protection fund or surplus. (*Id.*)

Appellants contend that the inserts were "materially misleading" as to the amount of surplus available for dividends. (AOB 47.) Each report to policyholders clearly set forth the total amount of Policyholder Protection Funds or surplus. (*See* AA13-03521-31, AA22-06163-6165, 06169-6186.) Under the heading Policyholder Protection Funds, that total is broken into different categories, including "Funds for the Protection of State Farm Mutual Policyholders," "Investment Fluctuation Reserve" and "Funds Assigned for Protection of Policyholders of Subsidiaries." (*Id.*) Appellants contend that policyholders may have believed that the category "Funds for Protection of State Farm Mutual Policyholders" represented State Farm's entire surplus and thus could have been misled as to the amount of surplus actually available for dividends. (AOB 47.) Likewise, Appellants argue that policyholders may have believed that the funds in the "Investment Fluctuation Reserve" were not part of the surplus, (*id.*), despite being listed under and included in the total amount of "Policyholder Protection Funds."[15]

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[15] The Illinois Department of Insurance was and is fully aware of State Farm's use of an investment fluctuation reserve in annual statements and approved its use as a permitted practice under Statutory Accounting Principles. (*See* AA22-06214:27-6215:11.) State Farm has consistently reported the accumulated unrealized capital gains on unaffiliated common and preferred stock as an investment fluctuation reserve since 1955, and the investment fluctuation reserve has always been clearly displayed as a component of surplus. (*Id.*) Unrealized capital gains are volatile, and *(cont'd)*

Contrary to Appellants' contentions, this is simply not the stuff of fraud. Appellants submitted no evidence that the inserts ever misled anyone. Named plaintiff Jerry Hill testified that he did not read the reports and Appellants' proposed expert Michael Toothman, a longtime State Farm policyholder, testified that he was not confused when he read them. (AA22-06222:10-6223:16, AA21-05969-5970.)

Moreover, the numbers and categories are taken directly from State Farm's audited and verified annual statements, as filed with the Illinois Department of Insurance and other state insurance departments.[16] (AA2-00333-334.) The sub-categories of Policyholder Protection Funds provide policyholders with more information, not less, and there is not a shred of evidence to indicate that State Farm is trying to make its surplus appear smaller than it is, as Appellants claim. In fact, some of Ed Rust, Jr.'s messages to policyholders, included in the annual inserts, proudly announce *increases* to surplus and emphasize State Farm's financial strength. (*E.g.*, AA13-03524-3526.) Finally, it is telling that Appellants have offered no motive for this alleged – and non-existent – fraud. *See Lewis v. Playboy*

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setting forth this component of surplus separately gave State Farm's officers and Directors immediate access to that financial information. (*Id.*)

[16] Notably, Illinois insurance statutes require that insurance company advertisements that provide information as to the company's financial condition must use figures that "correspond to the figures contained in the preceding verified statement." 215 ILCS 5/148.

Enters (Ill.App.Ct. 1996) 664 N.E.2d 133, 139 (affirming summary judgment under business judgment rule where the court "found no evidence of improper motives"). . *Cf. Kelly*, 254 A.2d at 71 (fraud exception not shown by incorrect reporting of payments to county as taxes where "there [was] not a shred of evidence to show that this procedure was adopted for sinister reasons").

4. Appellants' Other Allegations Of Fraud Also Lack Merit

Appellants complain about State Farm's recognition of the potential tax liability on unrealized capital gains. (AOB 47-48.) During the class period, this practice was approved by the Illinois Department of Insurance and is now *required* by the NAIC. ((*See* AA22-06214); 1 NAIC, *Accounting Practices & Procedures Manual* SSAP No. 10 ¶ 14 (2004).) Appellants argue that if State Farm liquidated assets from its surplus in order to pay dividends, any capital gains tax would supposedly be offset by tax deductions for dividends paid. (AOB 47.) The purpose of showing the potential capital gains tax liability is to reflect the amount available to State Farm if it needed to liquidate capital assets to pay an extraordinary volume of claims, not to show funds available to pay dividends. In fact, as with the Investment Fluctuation Reserve, this figure is designed to give a more accurate understanding of the strength of State Farm's surplus and the availability of funds to pay claims.

Appellants, relying on testimony from Loren Kramer, one of their proposed experts, further contend that the insert's figures conflicted with internal net worth figures used by State Farm by excluding salvage and subrogation and understating the cost of bonds. (AOB 48.) This argument is no more than an argument that State Farm should use the general accounting methods used by non-insurers, instead of the statutory accounting methods prescribed for insurance companies. It is undisputed that State Farm's handling of such matters was "in accordance with statutory accounting for insurance companies." (AA21-05960-5963.)

Appellants also assert that State Farm took "$3.6 billion in net worth 'off books' by over-funding management's pension plans." (AOB 48.) Appellants do not point to any evidence that State Farm's contributions to its auditor-approved *employee* pension funds ever exceeded lawful limits or that State Farm committed any other illegality with regard to its pension funds. (AA5-01378:7-17.) Moreover, State Farm and its policyholders benefited from the appreciation of the investments in State Farm's pension fund, which made it unnecessary for the Company to make additional contributions to the fund from 1998 to 2000. (*Id.*)[17]

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[17] Appellants also complain that the Board approved a capital contribution to one of State Farm's wholly-owned subsidiaries. However, Appellants fail to cite any case holding that the business judgment rule does not protect a decision by an insurance company to shore up a wholly-owned insurance subsidiary.

H. Appellants' Proferred Experts Failed To Create A Triable Issue Of Material Fact

1. The Trial Court Properly Struck Michael Toothman's Declaration

Michael Toothman opined that the Board did not have sufficient information to make informed decisions concerning the declaration of dividends and that State Farm could have paid at least $10 billion in additional dividends as of year-end 1998 and would still have had adequate surplus. (AA9-02492-2515.)

State Farm moved to strike the declaration on the grounds that Mr. Toothman was not competent to offer expert testimony regarding the Directors' uses of its surplus. (AA16-04531-4542.) It is undisputed that Mr. Toothman never advised a mutual insurance company on the subject of surplus, never served as a member of the board of a mutual insurance company, never consulted with a mutual company's board concerning surplus, never wrote on the subject of the surplus needs of a mutual insurance carrier, and otherwise had no knowledge or experience that would enable him to offer those opinions. (*See* MSJ Op. 17.) In fact, even Mr. Toothman did not perform the "surplus needs" analysis he claims State Farm should have performed. (*Id.*; *see also* AA16-04557:21-4558:12, 04559:4-11, 04560-4562, 04564:17-4565:12.) And with respect to the question of how much surplus an insurer must retain to guard against future

risks, Toothman conceded: "There's not only one right answer." (AA16-04577:3-8.)

The trial court struck Mr. Toothman's declaration, noting that this Court had found that mutual insurance companies use surplus in ways that are different from those of stock insurance companies. (MSJ Op. 17.) The trial court correctly ruled that "Mr. Toothman lacks the appropriate credentials to render an expert opinion on the analysis of surplus needs of a mutual insurance company." (*Id.*)

Appellants' authority does not demonstrate that the trial court abused its discretion. *See Redevelopment Agency*, 140 Cal.App.3d at 702-03 (no abuse of discretion where excluded expert's "qualifications did not sufficiently relate to the subjects about which he was asked to express an opinion"); *Miller v. L.A. County Flood Control Dist.* (1973) 8 Cal.3d 689, 700-01 (no abuse of discretion where excluded expert had no "close involvement" in area of proffered testimony).

In *Jeffer, Mangels & Butler v. Glickman* (1991) 234 Cal.App.3d 1432, 1444, the court reversed the exclusion of an expert's testimony regarding the standard of care for advisers of applicants to form a savings and loan where the expert was "familiar with the regulations on how to file applications, and he has consulted prospective applicants about the process of applying and the requirements of the government." The court in *Alef v. Alta Bates Hosp.* (1992) 5 Cal.App.4th 208, 220, held that the trial court

should have allowed the plaintiff to call a defense expert where defendants had conceded the expert's qualifications and the court found that the plaintiff could have established the expert's qualifications at trial. Here, Plaintiffs offered no evidence that Mr. Toothman's *actuarial* experience provided him with any of the *corporate governance* experience or experience governing mutual insurance companies he would require to render a qualified opinion on the Board's decisions related to surplus.

Moreover, even if the trial court erred in excluding Mr. Toothman's declaration, the judgment below should still be affirmed. The exclusion was a "separate and alternative" ground for the summary judgment ruling. (MSJ Op. 16.) As discussed above, Appellants failed to demonstrate that the trial court erred in ruling that State Farm had no obligation to conduct the "surplus needs" analysis described by Mr. Toothman. *See supra* Part IV.C.

2. Professor Bebchuk's Declaration Should Have Been Stricken Or Disregarded

Professor Lucian Bebchuk, who teaches corporate governance at the Harvard Law School, has never been on the board of a mutual insurance company, never advised the board of a mutual insurance company, and failed to familiarize himself with the way mutual insurance companies should (or even do) approach issues regarding surplus and dividends. (AA8-02034-35.) Yet he opined that the Board's "dividend and related

surplus decisions . . . were not sufficiently informed," were "without merit," that policyholders were provided "with an incorrect and misleading picture of State Farm's dividend policy and surplus," and the bylaws were amended to make it "much more difficult for policyholders to nominate themselves for election to the Board . . . ." (AA8-02033.)

The trial court noted that Appellants' separate statement of disputed facts relied entirely on Mr. Toothman, not Professor Bebchuk, concerning the Directors having supposedly been "insufficiently informed." (MSJ Op. 18 n.5.) The Court also noted that, while Professor Bebchuk criticized the Board for having failed to determine the "minimum level" of adequate surplus, Professor Bebchuk opined only that this failure rendered it "doubtful" that the Board was able to make an informed decision. (*Id.* at 18.) Appellants now complain that the trial court should have known that when Professor Bebchuk said "doubtful" he really meant "definitely." (AOB 29-30.)

The court did not abuse its discretion when it read Professor Bebchuk's declaration as failing to state that the Board breached its duty of care. (MSJ Op. 18.) Appellants make absolutely no effort to explain what qualifications Professor Bebchuk has that would allow him to opine that the Board's handling of surplus was neither "rational or in good faith" so as to overcome the business judgment rule presumption. (AOB 29-30.)

Appellants argue that the trial court should have considered Professor Bebchuk's "clarifying" declaration submitted in support of their motion for a new trial. (AOB 29.) However, Professor Bebchuk's "clarifying" declaration was not properly before the trial court when it ruled on State Farm's motion for summary judgment. *E.g., Jacob v. Retail Clerks Union* (1975) 49 Cal.App.3d 959, 966 (refusing to consider clarifying declaration submitted in support of motion for a new trial and holding: "the validity of a summary judgment is to be determined solely by the sufficiency of the affidavits which were before the court when the motion was heard, and [the Court of Appeal] will consider only the facts before the trial court *at the time it rules on the motion.*") (emphasis added); *Hollywood Screentest of Am. v. NBC Universal* (2007) 151 Cal.App.4th 631, 643 (Rule 437c "does not allow for the submission of additional evidence by the opposing party after the moving party's reply.").

Moreover, Professor Bebchuk's "clarifying" declaration is not properly before this Court. The trial court struck Professor Bebchuk's supplemental declaration, (AA24-06862-65), and Appellants have made no claim in their appeal that the trial court abused its discretion when it did. Indeed, under *Jacob* and *Hollywood Screen Test, supra,* the trial court would have abused its discretion if it had considered the "clarifying" declaration. 49 Cal.App.3d at 966; 151 Cal.App.4th at 643. Appellants' reliance on *Tortorella v. Castro* (2006) 140 Cal.App.4th 1, is also

misplaced. (AOB 30 n.9.) The court in *Tortorella did not* consider a supplemental declaration submitted in support of a motion for a new trial and never suggested that the trial court abused its discretion by not doing so. 140 Cal.App.4th at 13.

I. As A Matter Of Illinois Law, Appellants' Contract Claims Fail Because The Terms Of Their Insurance Policies Do Not Give Them A Right To Dividends Other Than As Declared By The Board

As the trial court explained, "[u]nder the governing insurance policies and the company's bylaws, the Board was empowered to declare a dividend, but it had no duty to do so and in particular had no duty to pay out 'excess' surplus in dividends." (MSJ Op. 10.) Therefore, even if this Court concludes that the Board's surplus management is not protected by the business judgment rule, the judgment below should be affirmed because Appellants have no contractual right to a dividend.

Under both Illinois law and the terms of Appellants' insurance contracts, a dividend declaration by State Farm's Board is a precondition to any right by a policyholder to receive a dividend. Under the policies, the Board has unfettered discretion to declare, or not declare, dividends. For example, the Hills' insurance policy contains the following provision governing dividends:

> While this policy is in force, the first insured named in the declarations is entitled to vote at all meetings of members and to receive dividends the Board of Directors *in its discretion*

may declare in accordance with reasonable classifications and groupings of such policyholders established by such Board.

(AA2-00365 [UF:4] (emphasis added).)

There is nothing in the policy language that creates a contractual right to a dividend. Rather, under the plain language of the policies, no entitlement to receive a dividend can arise unless and until the Board declares a dividend. As the *Lee* decision explains, a policyholder's "reasonable expectation" is "that he or she is purchasing insurance and *may*, in the discretion of the Board, receive dividends or other distributions." *Lee*, 50 Cal.App.4th at 723-24. *See also Boynton v. State Farm Mut. Auto Ins. Co.* (Ga.Ct.App. 1993) 429 S.E.2d 304, 306-07 (State Farm's policy language gives policyholders no contractual right to dividends except as declared by the company's Board of Directors).[18]

Further, as the trial court found, the language of the policy provision is permissive, leaving the decision regarding whether to declare a dividend – and if so, in what amount – to the Board. (MSJ Op. 5-6.) The provision uses the permissive "may," not the mandatory "shall." *See Meyers v. Rockford Sys., Inc.* (Ill.Ct.App. 1993) 625 N.E.2d 916, 922 ("In Illinois, courts interpret the word 'may' in private contracts as permissive and not

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[18] Two cases cited by Appellants for the first time on appeal – *Coons,* 13 N.E.2d 482 and *Ford v. Ford Mfg.* (1921) 222 Ill.App. 76 – are inapposite in this regard because both involved an asserted right to an *already declared dividend*. 222 Ill.App. at 85-89; 13 N.E.2d at 484-85.

mandatory."). In short, State Farm policyholders have no contractual right to dividends except as declared by State Farm's Board. *See Lee*, 50 Cal.App.4th at 723-24.

Courts across the country have explicitly rejected, as a matter of law, the contention that provisions such as the one at issue confer any contractual right on the policyholder to dividends except as declared by the insurance company's board of directors. In *Boynton,* for example, the Georgia Court of Appeal affirmed the trial court's dismissal as a matter of law of a policyholder's contract claims for dividends, concluding that under the contract language the policyholder "was entitled to share in company earnings and savings only if and to the extent dividends were declared by the Board in its discretion . . . ." 429 S.E.2d at 306.

Similarly, in *Churell v. Pioneer State Mut. Ins.* (Mich.App. 2003) 671 N.W.2d 125, 129, the court held that policyholders were not as a matter of law entitled to compel a distribution of dividends or surplus given the absence of any "statute, company bylaw, or contract provision according them that right." *See also, e.g., Indianer v. Franklin Life Ins.* (S.D. Fla. 1986) 113 F.R.D. 595, 599-600; *Burns v. Mass. Mut. Life Ins.* (S.D. Iowa 1986) 653 F.Supp. 77, 79, *aff'd* (8th Cir. 1987) 820 F.2d 246; *Dryden v. Sun Life Assurance* (S.D. Ind. 1989) 737 F.Supp. 1058, 1065, *aff'd* (7th Cir. 1990) 909 F.2d 1486.

There was no breach of contract as a matter of law. The judgment of the trial court should be affirmed.

V. CONCLUSION

For the foregoing reasons, State Farm prays that the judgment below be affirmed. The trial court correctly found that the decisions made by State Farm's Board concerning surplus were rational, informed and were protected by the business judgment rule.

Dated: August 1, 2007

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RULE 8.204(c)(1) CERTIFICATE

The undersigned counsel hereby certifies, pursuant to Rule 8.204(c)(1) of the California Rules of Court, that Respondent's Brief uses a proportionally spaced Times New Roman 13-point typeface, and that the text of the brief totals 13,843 words, including footnotes, according to the word count provided by Microsoft Word, the word processing software used to prepare the brief.

Dated: August 1, 2007

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STATE OF CALIFORNIA, COUNTY OF SAN FRANCISCO

I am employed in the county of San Francisco, State of California. I am over the age of 18 and not a party to the within action; my business address is 4 Embarcadero Center, Suite 3800, San Francisco, California 94111.

On August 1, 2007, I served the following document described as:

DEFENDANT-RESPONDENT'S BRIEF

on the interested parties in this action by placing true copies thereon enclosed in sealed envelopes addressed as follows:

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I declare under penalty of perjury under the laws of the State of California that the above is true and correct.

Executed on August 1, 2007, at San Francisco, California.

Pat Owens

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