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INSURANCE RATE LITIGATION

Judith K. Mintel

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A Survey of Judicial Treatment of Insurance Ratemaking and Insurance Rate Regulation

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Preface

The idea for this book came from my decision to update an article by Roy C. McCullough entitled ''Insurance Rates in the Courts'' published in the June and July 1961 issues of the *Insurance Law Journal*. When this project began, the intention was to produce a similar journal article surveying insurance rate litigation between 1960 and the present using basically the same organization followed in the seminal article. However, the volume of reported cases during the last twenty years was much larger than anticipated and the issues being litigated had expanded dramatically. The project grew as my study progressed, and the resulting book surveys more than three hundred disputes involving insurance ratemaking and insurance rate regulation.

The fruition of this project would not have been possible without the consistent encouragement and criticism of Roy McCullough, and it is with gratitude that I acknowledge his continuous and valuable assistance to me in this effort.

Once an initial draft was prepared, a number of my associates cooperated by reading and commenting on the manuscript. I would like to give special thanks to Michael J. Miller and James F. Perry who unselfishly shared their time and knowledge to improve this work. Needless to say, none of those who read the manuscript is responsible for any errors in concept or detail that may remain.

I would be especially remiss not to mention the cheerful and competent assistance given to me in preparing this manuscript by Kathy Litwiller. Despite much other work, unreasonable deadlines, and unending revisions, Kathy effortlessly managed to prevail and produce an extremely good–looking manuscript that was very helpful to me and my publisher. We are both grateful.

Insurance Rate Litigation

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1 INTRODUCTION

Trends in Insurance Rate Litigation

Litigation concerning government regulation of insurance rates has been growing rapidly during the last decade. This growth stems from a variety of causes including changes in the structure of the insurance market, which have resulted in greater independence in ratemaking among insurance companies. In some jurisdictions, these changes in the marketplace have been followed by changes in the basic thrust of insurance rate regulation — from the traditional regulation of concerted pricing to a new policy involving regulation of windfall or excess profits on either a prospective or retrospective basis. Where this new policy has been effected rate regulation of increasing complexity has ensued. A tiered pricing system results in which rates are regulated by government based in part on a company's size and market penetration as well as the classical cost of service criteria.

Despite these changes, there have been relatively few insurance rate cases in the past when compared with the amount of litigation involving the rates charged by public utilities. Possibly the paucity of insurance rate cases is due to the absence of rate regulation for other than solvency purposes in many jurisdictions in recognition of the absence of any true insurance monopoly. It may also be due to the fact that insurers have some control over their size and market penetration. Thus, if rate needs are not satisfied due to excessive or arbitrary regulation, internal changes in operating procedures can be implemented to reduce growth and control losses. These changes adjust rate needs to the level allowed without litigation.

Political activity growing out of concern about the necessity and lack of affordable insurance seems to be increasing on the federal level and in a number of states. This activity is counter to the predominant view in most states that government regulation of insurance rates is, at best, unnecessary and, at worst, economically destructive. On the one hand, it is argued that without government regulation of rates, insurance companies will reap excessive profits while treating individual policyholders in an unfair and discriminatory manner. This can be tolerated no longer; the aggregate of money involved is large but, more important, it is a significant portion of each consumer's budget. Additionally, it is argued that elimination of discriminatory treatment of individuals must be achieved at all costs for ethical reasons. Thus, the conclusion is that more extensive regulation of insurance rates makes sense from a social and political point of view.

On the other hand, it is argued that government regulation of insurance rates has been less successful in preventing excessive and unfairly discriminatory rates than regulation of the market by competitive forces. In some instances government regulation has adversely affected competition and its resultant benefits. Also, the regulation of rate classification criteria through the unfair discrimination standard has evolved into attempts by government to allocate products in short supply due to inadequate pricing. Hence, the deregulation of insurance rates is the most sensible economic point of view. These two divergent views are clashing demonstrably in courtrooms around this country.

Whether competition is considered the fundamental rate adjustment criteria, or whether the social and political perceptions of regulators are deemed primary, an arithmetic factor is always central to the debate over appropriate rate levels. The arithmetic factor comes into play as a method of adjusting rates to cover the costs of running an insurance business. Past costs are compiled into various statistics of losses and expenses by the insurance company. Using simple arithmetic, current rate levels in most insurance lines can be adjusted to cover expected changes in losses and expenses during a future period as well as provide for reasonable profit.

For those not intimately familiar with ratemaking terminology, it is easy to assume that insurance ratemaking involves abstruse, esoteric forms of higher mathematics in conjunction with actuarial predictions of precision. This is not so. With some exceptions — such as workers' compensation insurance, the more complicated experience rating plans and some trend and credibility calculations — rate revisions involve only arithmetic and the simpler forms of algebra. Since revisions are an attempt to forecast the future, precision is impossible. In the final analysis, the greatest difficulties in insurance ratemaking do not require access to data or a knowledge of complicated mathematics, but rather the appropriate exercise of informed judgment. Thus, the particular political, social or economic perceptions of those involved in the ratemaking process become critical when analyzing the various legal positions taken.

Past insurance rate litigation has dealt primarily with property and casualty personal lines insurance, such as private passenger automobile and homeowners insurance. This is because social and political concerns have most often surfaced in these lines, consequently entailing heavy regulation. Workers' compensation insurance and medical malpractice insurance rates have received the most regulatory attention in the commercial lines; credit life and health insurers have become more embroiled in rate litigation than any other portion of the life and disability insurance industry. Attempts by regulators to control the rates charged by Blue Cross and Blue Shield plans for hospital and physician services have also resulted in significant rate litigation. Many of the legal principles applied to one line of insurance frequently apply to other lines.

Rate Regulatory Laws

In each of the fifty states and the District of Columbia, laws have been adopted and executive departments established for the purpose of regulating the business of insurance. Among the many aspects of this regulation is control of the rates charged for various forms of insurance. Although regulation of insurance rates began as early as the first decade of the nineteenth century, it existed only for limited lines of insurance and in relatively few states until the late 1940s. Up until that time, the regulation of insurance rates was left to the states by the federal government.

Property and Liability Insurance

In *South–Eastern Underwriters Asso. v. United States,* 322 U.S. 533, 88 L.Ed. 1440, 64 S.Ct. 2923 reh. denied, 323 U.S. 811, 89 L.Ed. 646, 65 S.Ct. 26 (1944), the United States Supreme Court held that the sale of property–liability insurance was interstate commerce and thus subject to the provisions of the federal antitrust laws. The decision made illegal numerous private rate–fixing agreements created by the rating bureaus then determining most insurance rates in the property and liability field. The next year the 79th Congress passed the McCarran-Ferguson Act (Public Law 15). This law reaffirmed the state's power to regulate insurance by providing an antitrust exemption for the business of insurance to the extent it is regulated by state laws. As a result, state legislatures adopted rate regulatory laws for the purpose of gaining the antitrust exemption for their property–liability insurance industry and allowing the continuation of rating bureau activity. The economic thinking that formed the basis of this approach was the following: If government is to allow the noncompetitive activities carried on by insurers through rating bureaus, then direct government regulation of rates should be substituted for competition to assure that rates are reasonable.

In the beginning, laws adopted in various states had many similarities. Most followed the provisions of a model rating bill recommended by the National Association of Insurance Commissioners (NAIC) and the All–Industry Committee that worked with that association. Under this model law an insurer's rates must not be inadequate, excessive nor unfairly discriminatory. Insurers must fill the rates that they intend to use with the state insurance regulatory official. These filed rates cannot be used until approved by the insurance commissioner or until they have been on file for a certain period without any action on the commissioner's part. Rates in use can be disapproved at any time on a prospective basis. Rating bureaus are permitted to operate in the state if licensed and may make rate filings on behalf of member insurers. Membership in any bureau is optional and members can request permission to deviate from bureau rates.

Since the 1950s local variation in statutory patterns has increased. Quite a few states now have rating laws that vary widely from established country wide patterns. In some state statutes different words are used to convey the same result achieved in other states, and sometimes there are intentionally different rating procedures, methodology or standards. A few states however, such as Texas and Massachusetts, have reserved the ratemaking function in some lines as government responsibility. In these states, rating bureau membership is mandatory and the commissioner fixes rates rather than approves those filed by insurers. Most other states continue to operate under "prior approval" laws which feature independent insurers and rating bureaus as the moving force in ratemaking with strong regulatory constraints. Still other states have adopted competitive rating laws of various sorts which enable insurers initially to price with considerable freedom. But restrictions are subsequently placed on collective rate–setting in these situations and, in some cases, on the earning of excess profits by insurers.

Workers' Compensation Insurance

Ratemaking for workers' compensation insurance is now entrusted in practically all states to official rating bureaus established by the states themselves, or to the National Council on Compensation Insurance which is the licensed rating bureau in most states. Adherence to rates promulgated by the rating bureau is sometimes required by all insurers providing coverage in a state. Even in those states where bureau membership is not required, insurers voluntarily elect to become rating bureau members. In many states, workers' compensation insurance is regulated under the same chapter dealing with other property–liability insurance rates usually with some additional regulatory constraints. Independent pricing by individual insurers is extremely rare in this line although there is extensive variety in the rating plans and dividend arrangements offered.

Life and Health Insurance

There is usually no portion of the insurance code providing for direct state regulation of rates for life insurance and most types of health insurance. The authority used for regulation of rates in these lines of insurance often resides in the Unfair Trade Practices Act or in the policy forms approval provisions of the Insurance Code. For example, the model NAIC Unfair Trace Practices Act contains language that prohibits the "making or permitting of any unfair discrimination between individuals of the same class and of equal expectation of life and of essentially the same hazard in the amount of premium, policy fees or rates charged . . ." Also, a typical policy forms approval law prohibits the use of any policy form that is not approved by the commissioner and further provides "the commissioner may disapprove the form if the benefits provided therein are unreasonable in relation to the premium charged." The lack of direct rate regulation in the life and health insurance lines is probably because pricing in these lines has remained independent and there is no equivalent to the rating bureau that at one time dominated ratemaking in property–casualty lines.

Similarly, the rates charged for credit life insurance and credit accident and health insurance are regulated indirectly through the use of the Unfair Trade Practices Act and policy forms approval provisions of the statutes. Credit insurance protects lenders against economic loss resulting from the death or disability of the debtor during the term of the loan. The rates for credit insurance have received much greater regulatory scrutiny than those for other life and health lines because the dominant marketing arrangement for credit insurance is perceived to be anti–competitive. However, the anti–competitive nature of the sale of credit insurance does not involve concerted pricing. Most credit insurance is sold by the creditor in conjunction with the extension of credit. It is this arrangement that is anti–competitive because the insurance consumer is likely to view the purchase of insurance as of secondary importance to the loan transaction, or may easily be led to believe that the purchase of insurance is a prerequisite to obtaining the loan. This results in the highest volume of credit insurance sales for the company charging the highest price and paying the highest sales commission. There is little or no opportunity to shop for the lowest price credit insurance. The determining factor in sales is often the amount of sales commision paid to the creditor. Because of these aspects of credit insurance marketing that create financial incentives for