CAUSE NO. D-1-GV-02-002501

CHARLES O. "CHUCK" GRIGSON Intervenor – Plaintiff	§	IN THE DISTRICT COURT
v.	§	
THE STATE OF TEXAS, THE TEXAS DEPARTMENT OF INSURANCE, AND THE TEXAS COMMISSIONER OF INSURANCE, Plaintiffs,	§	OF TRAVIS COUNTY, TEXAS
v.	§	
FARMERS GROUP, INC., *et al.* Defendants.	§	261ST JUDICIAL DISTRICT

OFFICE OF PUBLIC INSURANCE COUNSEL'S AMICUS CURIAE BRIEF ADDRESSING PROVISION RESTRICTING REGULATORY AUTHORITY IN THE CURRENT VERSION OF THE SETTLEMENT AGREEMENT

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TABLE OF CONTENTS

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TO THE HONORABLE JUDGE JENKINS:

This Amicus Curiae brief is respectfully filed by the Office of Public Insurance Counsel for the State of Texas ("OPIC") asserting that Paragraph 6 of Section IX of the Second Amended Settlement Agreement titled "Management Fee" ("Paragraph 6") is inappropriate and illegal and must not be included in any proposed settlement agreement. Paragraph 6 attempts to prohibit the Texas Department of Insurance ("TDI") from evaluating any aspect of the Zurich/Farmers management fee in any future evaluation of any Farmer entity's expense structure and/or rate

filing.[1] This brief will address why this section must not be included in any future settlement agreement approved by the Court. The basis of OPIC's argument is simple: TDI cannot be restricted by agreement from performing its statutory duty to regulate property and casualty insurance rates. There is no logical dispute that TDI has the statutory duty to analyze, evaluate, and regulate all components of a rate filed by a regulated insurer. As drafted, Paragraph 6 would preclude TDI from considering certain expenses (the management fee) as an individual expense component. Without oversight of all rate components, TDI cannot meet its statutory duty to determine whether a rate is inadequate, excessive, or unfairly discriminatory as required by Section 2251.051 of the Texas Insurance Code.

I. INTERESTS OF THE OFFICE OF PUBLIC INSURANCE COUNSEL

OPIC is required by statute to assess the impact of insurance rates, rules, and forms on Texas consumers. OPIC's statutory authority also requires that it advocate on behalf of Texas insurance consumers when, in its judgment, consumers need representation of their interests in insurance matters. This brief is necessary because the existence of Paragraph 6, or any future version of same that renders the same result, will be used by Farmers entities to prevent the complete and fair evaluation of their rates. While OPIC would maintain that an agreement reached by Farmers and TDI would not be binding upon OPIC, approval by this Court would impede OPIC's efforts to meet its statutory duties as Farmers would likely assert that OPIC

[1] *See* proposed Second Amended Settlement Agreement, Sec. IX, Para. 6, which states:

> 6. Management Fee. For the Released Parties and any other company or reciprocal or inter-insurance exchange associated or affiliated with the Released Parties, and regardless of whether such entity is or is not subject to rate regulation in Texas, TDI agrees henceforward that it will not consider the management fee (profits or expenses) as a separate element in its evaluation of such company's expense structure or consider such management fee in the rate process generally, but may consider the over-all expense component of the rate as it compares the companies' expenses with other agency distribution companies doing business in Texas. This section does not preclude TDI from evaluating overall rate levels as authorized by law.

would be precluded (as TDI would potentially be) from evaluating the management fee expense component. OPIC was not paid to prepare this brief and this brief represents OPIC's own independent position.

II. PROPRIETARY RECIPROCAL EXCHANGES REQUIRE MORE RATE OVERSIGHT, NOT LESS

Proprietary reciprocal exchanges pose unique challenges for regulators. This Court has been made aware of what has been described as the "dynamic conflict" that exists between Farmers Group, Inc. ("FGI"), the attorney-in-fact, and the Exchanges, which are composed of the subscribers who are FGI's insurance clients and to whom FGI owes a fiduciary duty.[2] This conflict is not a new phenomenon and the problems with this management structure are analyzed thoroughly in Chapter 8 of the 1969 book titled *The Regulation of Reciprocal Insurance Exchanges*.[3] The Chapter 8 Summary provides good insight into one important reason why the profit and expenses of the attorney-in-fact should always be considered by TDI. It states:

> The practical effect of the proprietary arrangement is that the financial and operating data are split and likely to be obscured between the two entities. The financial statement of the exchange indicates only the aggregate management fee paid the attorney-in-fact corporation. Many of the operating expenses of the exchange and the net profits derived from the exchange are on the private books of the attorney-in-fact corporation.[4]

The conflict that inherently exists in proprietary reciprocal exchanges requires more oversight, not less. The reality is that the attorney-in-fact:

> 1) Is controlled by a group that is separate from the insurance consumers who own the exchanges, and
>
> 2) Derives profits from the management fees paid by the exchanges. It is also important to note that the management fee is based on the total amount of written premiums, not the actual profit of the exchange.

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[2] *See Fogel v. FGI*, 74 Cal. Rptr.3d 61, 66 (Cal. App. 2008, pet. denied).
[3] The text of Chapter 8 is attached as **Exhibit 1**.
[4] **Exhbit 1** at 157.

This reality requires that the state insurance regulator must pay more attention to this type of management structure to ensure proper oversight of insurance rates on behalf of Texas insurance consumers.

III. THIS IS A REAL PROBLEM

The excessiveness of the FGI management fee and its effect on the expenses of the Exchanges (and thus the ultimate rates charged to consumers) is a real problem that has existed for over 20 years. This issue was regularly litigated in the rate benchmark hearings from 1996 to 2000. As a result of evidence presented by OPIC and others at those hearings, TDI consistently reduced the Exchanges' allowable fixed expenses to account for the percentage of profit paid to FGI as part of the FGI management fee.[5] Then in November 2002, TDI entered into the original Memorandum of Understanding ("MOU") with Farmers where TDI agreed to limit its evaluation of the management fee.

Farmer's practice of including the total amount of FGI's profit from the management fee as a general expense of the Exchanges has not changed. The 2013 TDI chart titled *Comparison of Expense Provisions in Company Homeowners Filings* indicates that Farmers' General Expenses continue to be at least 6% higher than its competitors.[6] This has been a consistent and ongoing problem for at least twenty years. OPIC contends that the MOU has exacerbated this issue. It has only benefited FGI by making it more difficult for TDI and OPIC to accurately account for the total amount of FGI profit included in the Exchanges' general expenses. This situation should not be allowed to exist into perpetuity.

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[5] Excerpts from TDI Commissioner Orders dated July 29, 1996, August 21, 1997, November 3, 1997, December 18, 1997, November 12, 1998, and April 10, 2000 are attached as **Exhibit 2.**

[6] The 2013 TDI chart titled *Comparison of Expense Provisions in Company Homeowners Filings* is attached as **Exhibit 3.** This report compares the expenses of Texas Farmers Ins. Co., State Farm Lloyds, Allstate Texas Lloyds, Allstate F&C Ins. Co., Travelers Lloyds of Texas, and Travelers Home and Marine.

IV. WHAT IS PARAGRAPH 6's PURPOSE?

An important question to ask regarding Paragraph 6 is: What is it supposed to do? Is it really intended to prohibit TDI from evaluating the profits and expenses of FGI (the attorney-in-fact of the exchanges) when analyzing the expense structure of any Farmers-related entity during any part of the rate filing process? If that is really the point, how does this comport with the Texas Insurance Code?

Simply, it doesn't. The Texas Insurance Code confers upon TDI several relevant regulatory duties that cannot be waived. TDI is statutorily responsible to a) analyze, evaluate, and regulate reciprocal exchanges pursuant to Texas Insurance Code Chapter 942 ("Chapter 942"), and b) analyze, evaluate, and regulate rates charged by insurers to Texas insurance consumers pursuant to Texas Insurance Code Chapter 2251 ("Chapter 2251") and Texas Administrative Code §5.9332 ("§5.9332").

V. TDI's DUTY TO REGULATE EXCHANGES PURSUANT TO CHAPTER 942

Chapter 942 applies to all reciprocal and interinsurance exchanges licensed by TDI. Subchapter E (titled "Regulation of Exchanges"), §942.201 requires the attorney-in-fact to prepare and present to the insurance commissioner an annual report that provides: A) the total amount of premiums or deposits collected; B) the total amount of losses paid; C) the total amounts returned to subscribers; and **D) the amounts retained for expenses.** In addition, §942.202 states that the **business affairs and assets of an exchange**, as shown at the office of the attorney in fact, **are subject to examination by the department.** It appears that Paragraph 6 is an attempt by FGI to prevent TDI from examining **the business affairs of the exchange and the amounts retained for expenses.** Paragraph 6 would be a voluntary waiver by TDI of its

regulatory duties and its authority over FGI and the Exchanges that purports to continue into perpetuity regardless of any improper future actions by FGI or statutory changes to TDI's regulatory powers. This cannot be allowed.

VI. TDI's DUTY TO REGULATE RATES PURSUANT TO CHAPTER 2251

TDI is charged with regulating insurance rates in Texas pursuant to Chapter 2251. §2251.051(b) states that a rate is excessive if the rate is likely to produce a long-term **profit** that is unreasonably high in relation to the insurance coverage provided. It is beyond question that the management fee payment by the Exchanges to FGI includes a large portion that is purely profit being paid directly to FGI. The fee history and FGI's own statements reveal that the management fee is typically 50% profit and 50% actual expenses incurred.[7] Section 2251.101(b) requires that the Commissioner by rule shall: 1) determine the information required to be included in the filing, including: (b) statistics or other information to support the rates to be used by the insurer, including information necessary to evidence that the computation of the rate does not include disallowed expenses.

To apply Chapter 2251, TDI created several TAC rules, including §5.9332. Section 5.9332(e) states that insurers **must** provide supporting information as necessary for the department to establish that a filing produces rates which are not inadequate, excessive, or unfairly discriminatory for the risks to which they apply. To explain what supporting information insurers **must** provide, §5.9332(e) provides great detail. It states that actuarial supporting information that is submitted with the filing **should** include all expense and profit provisions to the extent applicable. In addition, it requires that a brief description of the methodology and assumptions used to arrive at the profit provisions underlying the proposed rates be provided with a filing.

[7] Zurich Insurance Group 2013 Annual Report page 115 is attached hereto as **Exhibit 4**.

To actually regulate whether the profit provisions submitted by FGI on behalf of the Exchanges are excessive, the management fee itself must be scrutinized. Under Texas law, the plain language of the statutes and rules should apply.[8] The plain language of Chapter 2251 and TAC rules 5.9330 – 5.9332 state that all profits and expenses should be considered when evaluating rates. To quote prior findings by the TDI Commissioner:

> "The Commissioner is persuaded…that the Farmers Insurance Group management fees expenses include a ***substantial transfer of profit*** in addition to the cost of providing services."[9] "The Commissioner is also persuaded that the amount of the reported expense ratio of the Farmers Insurance Group is inflated by 5.5 percentage points due to the management fee profit provision."[10] (emphasis added)
>
> "The Farmers Insurance Group claimed as expense to its affiliated management company amounts which ***significantly exceeded the cost of management services provided.*** The excess amounts paid to the Farmers Insurance Group's affiliated management company amounted to 5.5 percent of premium… Deducting that portion of the management fee that represents the excess amounts paid from fixed expenses, as proposed by OPIC, is reasonable."[11] (emphasis added)

It is necessary to analyze the management fee itself to evaluate the amount that is for actual expenses versus the amount that is simply profit being siphoned to FGI.

FGI may argue that Paragraph 6 as drafted does allow TDI to fully evaluate the rate filing as it specifically states "This section does not preclude TDI from evaluating overall rate levels as authorized by law" and allows TDI to evaluate FGI's expenses in the aggregate. However, this argument ignores the very nature of rate making and rate analysis. Rates are not merely made or evaluated on an aggregate basis by comparing the rates or rate components of different insurance companies. Instead, each company's own experience, performance, profit selections, reinsurance arrangements, expenses and numerous other factors must be individually evaluated

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[8] *See Mid-Century Ins. Co. of Texas v. Ademaj*, 243 S.W.3d 618, 623-625 (Tex. 2007).
[9] **Exhibit 2** - Benchmark Rate Hearing Dkt. No. 454-95-1280.G (1996).
[10] *Id.*
[11] **Exhibit 2** - TDI Commissioner Order No. 97-1105 (1997).

to determine if the rate selection is appropriate under Chapter 2251. These many factors, also referred to as rate components, are all considered by insurance companies when determining the appropriate rate selection. A regulator must be able to evaluate all rate components individually to determine if the final rate selection meets statutory guidelines. To shield certain factors from scrutiny undermines the veracity of any real rate analysis. This is not to say that the regulator must agree with each rate component value selection made by the insurance company. It is not unusual for a regulator to determine that an overall rate selection is reasonable even if it disagrees with some of the company's selections. For example, a regulator may find that a company's underwriting profit selection is too high yet the company's selected future loss trends are understated. If these selections effectively offset each other, the final rate selection isn't impacted and the regulator would not take issue with it. Without the ability to evaluate all rate components, the regulator is left to mere speculation. This was clearly not the Legislature's intent when drafting Texas's detailed rate regulation laws.

Finally, should FGI's management fee arrangement be spared from scrutiny, why shouldn't each property and casualty insurance company subject to rate regulation in Texas be afforded the same consideration for the rate component of their choice? Say insurance company X doesn't want its reinsurance purchases scrutinized because they are paying an above market price for coverage to a reinsurance company affiliated with its parent company. Shouldn't they be afforded the same benefit? Even if a rate component isn't necessarily suspect, it still must be subject to review in order to maintain proper regulatory oversight in accordance with Texas law. If TDI is restricted from regulating profit provisions in the Farmers rate filings, it would be both illegal and detrimental for the future of effective rate regulation overall.

VII. TDI HAS "EXCLUSIVE JURISDICTION" TO MAKE INITIAL DETERMINATION REGARDING EXCESSIVENESS OF RATES FILED BY INSURERS IN TEXAS

One reason this issue is so important is that TDI has been granted by the Legislature "exclusive jurisdiction" to regulate insurance rates in Texas. In Texas, an agency has exclusive jurisdiction when the Legislature gives the agency alone the authority to make the initial determination in a dispute by either 1) express legislative indication, or 2) by the creation of a pervasive regulatory scheme that indicates the Legislature intended for the regulatory process to be the exclusive means of remedying the problem to which the regulation is addressed.[12] When an agency has exclusive jurisdiction, a party must exhaust all administrative remedies before seeking judicial review of the agency's action and the courts have only a limited review of the administrative action once it gets that far.[13]

Chapter 2251 does create a pervasive regulatory scheme that allows for TDI to reject filed rates and it allows insureds, and/or OPIC, to request that TDI hold a hearing to address a certain rate filing. However, to do this, OPIC, TDI and others must have access to all relevant information that reveals the actual profits and expenses of the insurance company. Surely the Legislature did not intend to grant TDI exclusive jurisdiction to regulate rates only to have them be restricted from obtaining all the relevant information required to fully analyze whether the rate is excessive.

VIII. PARAGRAPH 6 VIOLATES THE SEPARATION-OF-POWERS DOCTRINE

The Texas Legislature has mandated that TDI regulate the business of insurance in Texas and ensure that the Texas Insurance Code is executed.[14] The Commissioner is the chief executive and administrative officer of TDI and is explicitly given the power to administer and

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[12] *Hancock v. Chicago Title Ins. Co.*, 635 F. Supp.2d 539, 554-556 (N.D. Tex. 2009); *Subaru of Am., Inc. v. David McDavid Nissan, Inc.*, 84 S.W.3d 212, 221 (Tex.2002).
[13] *Id.*
[14] *Hancock v. Chicago Title Ins. Co.*, 635 F. Supp.2d 539, 554-556 (N.D. Tex. 2009); TEX. INS. CODE §31.002.

enforce the Insurance Code.[15] The Legislature did not delegate to the Insurance Commissioner the ability to waive his or her statutory duty to regulate reciprocal exchanges or insurance rates. An officer of TDI that signs a final settlement agreement that includes paragraph 6 would violate Article 2, Section 1 of the Texas Constitution, which limits the executive branch's ability to interfere with the legislative branch's authority under the separation-of-powers doctrine.[16] The Legislature makes the law and the executive branch enforces the law. The executive branch, here TDI, cannot be restricted, even by voluntary agreement, from performing its regulatory duty into perpetuity.

IX. SIGNING AN AGREEMENT THAT INCLUDES PARAGRAPH 6 IS AN *ULTRA VIRES* ACT

Any agreement by an officer of TDI to waive its regulatory duties related to reciprocal exchanges and rate filings would be considered an *ultra vires* act. An act is *ultra vires* if it was performed without legal authority.[17] In the case at hand, an officer of TDI would not have the legal authority to bind TDI as it is beyond the scope of the officer's authority. If the final version of this agreement were to include paragraph 6, a declaratory judgment action would need to be filed directly against the signing officer, acting in his/her official capacity, to obtain an order that enjoins TDI and Farmers from acting on Paragraph 6 on the basis that it is beyond the scope of what a TDI officer, or anyone acting on TDI's behalf, is allowed to do under the statutory provisions of the Insurance Code. The state laws are created by the Legislature and detailed in the Texas Insurance Code.[18] A regulator cannot voluntarily agree to not to enforce certain

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[15] *Id.*at §31.021(a).

[16] *See* Third Court of Appeals August 29, 2013 Opinion in this case regarding disclosure of rate filing information under former Tex. Ins. Code §2251.107.; S*ee also* TEX. CONST. ART. II, §1; *Texas Boll Weevil Eradication Found., Inc. v. Lewellen*, 952 S.W.2d 454, 465-70 (Tex. 1997) (discussing delegation of legislative authority in context of separation-of-powers doctrine).

[17] *City of El Paso v. Heinrich*, 284 S.W.3d 366 (Tex. 2009); *TDI v. Reconveyance Services, Inc.*, 306 S.W.3d 256, 258 (Tex. 2010).

[18] *Id.*

provisions of the law into perpetuity. Additionally, in the interest of fairness, they should not agree to not enforce certain provisions against certain insurance entities while still enforcing these provisions against other insurance entities.

X. CONCLUSION

This brief explains why Paragraph 6 must be removed from any final version of the TDI/Farmers Settlement Agreement. While it is clear why FGI would seek this sort of beneficial arrangement, no rationale has been advanced to show that it is legal or even advisable from a public policy standpoint. What is abundantly clear is that it is beyond TDI's statutory authority and potentially benefits one insurance group over others. There are several insurance code chapters that require an analysis of the management fee when evaluating the expenses of the Exchanges and whether the overall rates are excessive. TDI does not have the authority to waive the requirements of these chapters. In addition, it is extremely bad policy to agree not to review the management fee paid to a proprietary attorney-in-fact corporation that has obvious motives to inflate its fee. TDI has regularly confirmed that Farmer's attorney-in-fact has continuously included a "substantial transfer of profit" in its management fee and the attorney-in-fact's own officers have confirmed as much in the past (this issue was presented to the Court in detail during the hearing on September 4, 2014).

Finally, OPIC respectfully recommends that this Court reject any proposed settlement agreement that includes any provision substantially similar in effect to the current Paragraph 6. If a settlement agreement is approved that includes a provision similar to Paragraph 6, it is likely that future legal action would be necessary to enjoin the enforcement of Paragraph 6 on the bases cited herein.

Respectfully submitted,

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