Automobile Insurance

Actuarial Models

Jean Lemaire

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Liberty Mutual v. Progressive
CBM2012-00003 Prog. Ex. 2014
CBM2013-00004 Prog. Ex. 2018
CBM2013-00009 Prog. Ex. 2027

Progressive Exhibit 2021
Liberty Mutual v. Progressive
CBM2012-00004

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3 NORTH AMERICA

United States (Mary Lou O'Neil)

Regulation

Background. Because regulation plays a prominent role in almost all aspects of the insurance business in the United States, we will discuss this subject first.

The first American regulatory insurance statutes date from the early 1800s. The purposes of these laws were to (1) raise revenue through taxes, (2) protect domestic insurers against competition from foreign and alien insurers, and (3) protect the public against insolvency and inequitable treatment by insurers. This early regulation was almost exclusively at the state level. The growth of the insurance business paralleled the growth of other industries during the late nineteenth and early twentieth centuries. Due to a combination of greed, poor business judgment, and dishonesty, many insurance companies failed. This led to several court investigations and, subsequently, tighter regulation of both expenses and prices at the state level. The industrial revolution fostered the growth of large monopolistic companies, which, in turn, fostered the enactment of several

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federal antitrust laws and acts, which applied to businesses involved in interstate commerce. Because the insurance business was not considered to be interstate commerce, it was at first considered exempt from the federal antitrust laws. However, in 1942 the U.S. Justice Department indicted the South Eastern Underwriters Association, based on the federal antitrust laws, citing that the defendants had (1) conspired to fix rates, and (2) conspired to monopolize interstate commerce. In 1944, in a landmark decision, the U.S. Supreme Court reversed prior precedent and ruled that insurance is commerce and, therefore, subject to federal regulation. Because of the great change in the status of insurance regulation and the desire of the states (represented by the National Association of Insurance Commissioners [NAIC]) to retain the authority to regulate the insurance business, in 1945, Congress enacted the McCarran-Ferguson Act, which provided for (1) continued regulation and taxation by the states, (2) application of the antitrust laws to the extent the insurance business is not regulated by the states, and (3) continued application of certain federal laws. Hence, the insurance business in the United States is regulated at the state level. The extent of this regulation differs by line of business and by state.

Generally, state insurance regulation is designed to control the activities of insurers who conduct insurance business within the state. In addition, there is also some regulation of agents, brokers, and others who market or service insurance products. Insurer regulation may be classified into three categories: (1) formation and licensing requirements, (2) supervision of operations, and (3) liquidation procedures. Specifically, regulation includes a purview of activities in the following areas: incorporation and licensing of domestic, foreign, and alien insurers; policy contract language; coverage to be offered; basis for selection of new business; basis for cancellation or nonrenewal of business; rates; claim handling practices; financial statement requirements (expenses, reserves for unearned premium and claims, asset and surplus valuation); investment portfolio composition restrictions; statistical data collection; agent licensing; countersignature requirements; unfair trade practices; taxation; liquidation; and suspension.

Because of their significance to private passenger automobile insurance, the areas of rate regulation and financial responsibility laws are described in detail below.

Rate regulation. To ensure that the insurance business is regulated by the states, and, therefore, exempt from the federal antitrust laws as provided by the McCarran-Ferguson Act, the NAIC, in 1945, sponsored the formation of an all industry committee, composed of representatives of 19 insurance trade organizations. The purpose of the committee, along with the federal

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legislative committee of the NAIC, was to study state regulation to determine the changes in state laws necessary in order to avoid federal regulation.

The result of the committee's work was the "all industry" bills, adopted by the NAIC as model legislation for the guidance of the states in complying with the requirements of the federal act. The major substantive rate standard recommended to the states in the all industry bills were: (1) that rates be *reasonable* and *adequate* for the class of risks to which they apply; (2) that no rate *discriminate unfairly* between risks involving essentially the same hazards and expense elements; (3) that consideration be given to past and prospective loss experience (including catastrophe hazards, if any) and to a reasonable underwriting profit. Rates are considered reasonable (not too high) and adequate (not too low) when they produce sufficient revenue to pay all losses and expenses of doing business, and in addition produce a reasonable profit.

Within this framework, the all industry committee sought to provide for as much price competition as possible but at the same time to protect the industry practice of bureau ratemaking because unrestricted competition had resulted in too many insurer insolvencies. Rating bureaus (associations of insurers whose purpose is to set rates) combine the premium, claim, and expense experience of member companies to determine rates. There are only a few rating bureaus; the largest for private passenger automobile insurance is the Insurance Services Office (ISO).

The final results of the all industry committee's work resulted in the enactment of six broad categories of rate regulatory laws in the various states.

1. *State-made rates laws.* Rates are set by the state with strict adherence by all insurers. Insurers are permitted to pay dividends to policyholders. Only a few states have enacted this type of law.
2. *Mandatory bureau membership laws.* Rates are made by rating bureaus to which all companies must belong. Companies may deviate from bureau rates only with specific approval of the state insurance department. Dividends may be paid to policyholders. Only a few states have enacted this type of law.
3. *Prior approval laws.* Rates must be approved by the state insurance department before they can be used. Bureau membership generally is permitted but not required. Insurers may also file their own rates independently. The majority of states have enacted this type of law.
4. *Modified prior approval laws (use and file).* Prior approval of rates is not required. However, rates must be filed with the state insurance

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department before they can be used. The state insurance department retains the right to subsequently disapprove rates.

5. *File and use.* Rates may be used and then filed with the state insurance department, which retains the right to subsequently disapprove rates.
6. *No file.* A few states do not require any rate filings.

Where a rate filing is required, generally every insurer must file (1) a manual of classifications; (2) the rates applicable thereto; (3) the coverage to be provided; (4) the underwriting rules to be followed in classifying and rating risks in accordance with the classification schedules and rates; (5) the unit of exposure or premium base applicable; and (6) all rating plans for adjusting classification rates in recognition of variations in hazard for individual insureds. In addition, supporting information is filed, which usually includes: (1) the experience or judgment of the insurer making the filing; (2) the insurer's interpretation of any statistical data that it relies upon; (3) the experience of other insurers or organizations; and (4) any other relevant factors.

Financial responsibility/Mandatory insurance laws. The concept of liability or responsibility for one's actions developed centuries ago as part of the common law. With the invention of the automobile, this theory of responsibility was extended to include liability for injury to both persons and property caused by an automobile. Also, as the number of vehicles on the road increased, the social/economic problems of the innocent injured party became more evident. Often the negligent party was not financially responsible, i.e., not able to pay for injuries caused to another. In an effort to protect these victims, all states enacted financial responsibility laws, beginning with Connecticut in 1926. These laws were intended to: (1) protect the injured party with a legal claim; (2) encourage or compel those using the highway to provide a degree of financial responsibility for the injury they may cause; and, (3) encourage safer driving. They require drivers to furnish evidence of financial responsibility in varying amounts—generally, $10,000 for injury to any one person in an accident, and $5,000 for damage to property. The required limits vary by state.

At the time of the accident, evidence of financial responsibility generally can be demonstrated in any one of several ways: (1) an insurer's certification; (2) posting of a bond; or, (3) cash deposit. The insurer's certification is the predominant means used to demonstrate financial responsibility.

Experience showed, however, that the financial responsibility laws did not satisfactorily meet the intended purpose of compensating the innocent

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